The New York

Certified Public Accountant

Vol. IX | *May • 1939* | No. 8

IN THIS ISSUE

Municipal Accounting

Clothing Manufacturing Accounting

Testimony of Expert Witnesses at S.E.C. Hearings

Current Events — Elections

Published by

The New York State Society of Certified Public Accountants

Single Copy 25 Cents : Per Annum $2.00

Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—*From the Certificate of Incorporation.*

The New York

Certified Public Accountant

Vol. IX *May · 1939* No. 8

TABLE OF CONTENTS

Published by

The New York State Society of Certified Public Accountants

15 EAST 41st STREET · NEW YORK

The New York Certified Public Accountant *is published monthly from October to June. Copies may be obtained at the office of the Society at twenty-five cents per copy, $2.00 per year. All other communications relating to this publication should be addressed to the Committee on Publications.*

CURRENT EVENTS

Calendar of Events

May 19-20—Four-State Conference—Hotel Claridge, Atlantic City, N. J.

May 22—7:45 P. M.—Special Meeting of Society—Subject: Consideration of the Report of the Special Committee on Auditing Practice and Procedure. Location: East Ballroom of the Hotel Commodore, Lexington Avenue and 42nd Street, New York City.

June 2—Sixth Annual Outing and Tournament. Location: Westchester Country Club, Rye, N. Y.

June 23-24—Sixth Regional Chapter Conference—Holl's Inn, Fourth Lake, Inlet, N. Y.

Plans for Sixth Regional Chapter Conference Nearing Completion

The Committee arranging for the program for the Sixth Regional Chapter Conference to be held at Holl's Inn on Fourth Lake, Inlet, N. Y., on June 23-24-25, 1939, has been working on a program of outstanding and current topics for discussion at this Conference.

A sports program is being arranged and members are assured of an enjoyable week-end at Holl's Inn. A notice of the business and sports program will be mailed to the members shortly together with reservation cards.

It is hoped that those who were with us last year will be with us again for the Sixth Annual Conference and that those who were not with us last year will make every effort to be with us as they are assured of a grand time.

Round-Table Forums

The third series of round-table meetings conducted on Wednesday evenings beginning with April 5, 1939, ended on May 10th.

The meetings were very interesting and have been well received by the members. Many comments received from those present indicate that a fourth series is eagerly awaited and will probably be arranged for the Fall.

It is expected that many of the papers presented at these meetings and extracts from the discussions will be published in subsequent issues of this publication.

Sixth Annual Outing

Members are being advised that the Sixth Annual Outing and Tournament of the Society will be held on Friday, June 2, 1939, at the Westchester Country Club, Rye, N. Y.

Many prizes have been selected for the golf and tennis tournaments. Tennis tournaments and informal golf will be held in the morning. Following luncheon the golf tournament will start and the tennis tournament will be continued. Dinner will be served at 7:30 P.M. at which the prizes will be awarded.

In addition to the F. W. Lafrentz, Walter A. Staub and S. D. Leidesdorf trophies for golf and tennis, there will be sixteen prizes for the golf and tennis tournaments and three door prizes at the dinner. The Committee has not spared expense in arranging for prizes.

Bridge, horseshoe pitching, and other entertainment will be arranged for those not playing golf or tennis.

A very interesting day is promised to all who attend. It is hoped that many members will be with us for the day and will bring their friends with them. If you have not sent in a reservation card to the Society's office, why not do so at once?

Resolution on Insurance Statement Approved

On April 26, 1939, there was sent to the members, in accordance with a resolution adopted by the Board of Directors at its meeting on April 6th, a letter from the Practice Procedure Committee covering the Committee's discussion on the Insurance Statement prepared by the National Association of Credit Men and a resolution of the Committee, approved by the Board of Directors, which the Committee agreed upon as expressing the attitude which the members should take in regard to the Insurance Statement.

At the Society's meeting on May 8th, the resolution was presented to the members for adoption and the resolution which is quoted below, was approved:

"WHEREAS, the National Association of Credit Men has promulgated a form of Insurance Statement to be furnished by debtors to credit grantors who are members of that Association, as a means of furnishing information concerning the insurance carried by debtors, and

"WHEREAS, The New York State Society of Certified Public Accountants recognizes the importance of the matter of insurance coverage and seeks to cooperate with the National Association of Credit Men in furnishing credit grantors accurate information regarding such insurance coverage, now therefore,

"BE IT RESOLVED: That members of the New York State Society of Certified Public Accountants, when requested by their clients, shall review the information contained in the Insurance Statement and shall make appropriate comments thereon in their reports, including such comments on the adequacy of the coverage as they may be able to make on the basis of ordinary business judgment, and not as experts in insurance."

May 8, 1939 Annual Meeting

At the annual meeting held on May 8, 1939, at the Waldorf-Astoria Hotel, at which Clem W. Collins of Denver, president of the American Institute of Accountants, delivered an address on "Accounting in the Public Interest", the following officers and five members of the Board of Directors were elected:

President .... Victor H. Stempf
First Vice-President .... A. S. Fedde
Second Vice-President Andrew Stewart
Secretary ...... G. Charles Hurdman
Treasurer .... Archie F. Reeve

Directors for Three Years:
Morris C. Troper
Warren W. Nissley
Norman Joseph Lenhart
Saul Levy
Frederick W. Wulfing

Members Honored

Copies of the Society's Ten-Year History Book were distributed to the members recently.

It will be noted that of the total membership of 123 at the end of the tenth year of the Society's existence, only twenty-eight members are surviving. The Society honored these twenty-eight members at its annual meeting held on May 8th at a dinner preceding the meeting, and by the presentation of a bound copy of the Ten-Year History Book to these members at the meeting.

Mr. Norman E. Webster made the presentation of these books to the members present, and in turn, Mr. Victor H. Stempf, Acting President of the Society, presented Mr. Webster with a bound copy of this book in appreciation of his untiring efforts and services in the compilation and preparation of this Ten-Year History Book.

Those members who were present at the meeting are as follows:

Leonard H. Conant
W. Sanders Davies
Harold B. Hart
Edward M. Hyans
Orrin R. Judd
Farquhar J. MacRae
James A. McKenna
Warrel S. Pangborn
Percy B. Rigby
Robert H. Rucker
William S. Salway
Frederic W. Squires

The following members found it impossible to be with us and it is regretted that they could not have been present to enjoy the honor that was accorded these members:

Edgar M. Barber
Chester P. Child
DeRoy S. Fero
August Fischer
Ferdinand W. Lafrentz
W. Paxton Little
Duncan MacInnes
Charles S. McCulloh
John B. Niven
H. F. Searle
Arthur W. Teele
Alexander L. Tinsley
Ferdinand C. Townsend
A. S. Vaughan
Peter C. Wiegand
Arthur Wolff

A Former President Passes On

William F. Weiss, a former president of the Society, passed away on April 16, 1939, after a brief illness.

Mr. Weiss, a member of the Society since June, 1914, served the Society as its Treasurer from 1907-1910, as its President from 1912-1913, and was elected a Director from 1913-15. He was also active on several committees of the Society.

The Board of Directors, at its regular meeting on May 8, 1939, adopted the following resolution on the death of William F. Weiss:

> "RESOLVED, That in the death of William F. Weiss, The New York State Society of Certified Public Accountants lost a loyal member who maintained a continuous membership in the Society for a period of thirty-seven years and who served the Society as its Treasurer for three years, as its President for one year, and as a director for two years.
>
> "The Board of Directors of this Society hereby records its sorrow at the death of Mr. Weiss and its appreciation of his professional spirit and exemplary action in so faithfully serving the Society and his chosen profession.
>
> "The Board of Directors directs that this resolution be incorporated in the minutes of its meeting and that a copy of it be sent to the family of Mr. Weiss."

Joseph Graef

Joseph Graef, a valued and esteemed member of the Society since June, 1914, passed away on March 25, 1939.

ELECTIONS

THE following is a list of applicants admitted to membership and associate membership in the Society and also associate members advanced to membership at a meeting of the Board of Directors held on May 8, 1939:

Membership

Jack Albin, 51 Chambers Street,
Of Albin & Albin.

Samuel Arum, 45 John Street,
Of Baumgarten & Arum.

Anson Beaver, 1 Cedar Street,
With R. G. Rankin & Co.

Joseph Burman, 17 East 42nd Street.

Ernest Walter Carr, 80 Broad Street,
With Miller, Donaldson and Company.

David A. Coffield, 136 East 57th Street,
Of Lewis & Coffield.

Jack Howard Greenberg, 1450 Broadway.

Meyer Gurien, 276 Fifth Avenue,
Of Gurien Audit Co.

Edwin Heft, 80 Maiden Lane,
With Touche, Niven & Co.

Henry Wallace Holt, 306 M. & T. Bldg., Buffalo,
Of Henry W. Holt & Co.

George Thomas Hubbell, 1013 Liberty Bank Bldg., Buffalo,
With Lucker & Severance.

Benedict B. Katz, 11 West 42nd Street.

Benjamin Koehl, 50 Court Street, Brooklyn.

Jacob Kwalwasser, 1359 Broadway.

John M. Long, 205 East 42nd Street.

Malcolm Thornton MacPhee, 56 Pine Street,
With Price, Waterhouse & Co.

Meyer L. Olf, 285 Madison Avenue.

Edward Peragallo, 425 Riverside Drive.

Harry J. Reicher, Empire State Bldg., New York,
Of Harry J. Reicher & Co.

Max Rothenberg, 1450 Broadway,
Of Kahn, Rothenberg & Co.

Roy A. Scholes, 1416 Temple Bldg., Rochester,
Of Williams & Thomy.

Herman Seidman, 11 Broadway.

Irwin Sturz, 1501 Broadway,
Of Louis Sturz and Co.

Louis Toll, 11 West 42nd Street.

Paul Weissman, 11 West 42nd Street.

Abraham Weitzman, 16 East 52nd Street.

Bernard Wiernikoff, 125 Park Avenue,
With S. D. Leidesdorf & Co.

Associate Membership

Nelson O. Argueso, 2 Rector Street,
With Ebasco Services Incorporated.

Robert Ashton Aspinwall, 350 Madison Avenue,
With Hurdman and Cranstoun.

Leon Blum, 271 Madison Avenue,
With Alexander Goldring & Co.

Morris Blumenkrantz, 25 Broadway,
With Louis M. Goldsamt.

Samuel M. Borisoff, 220 Cutler Bldg., Rochester,
With Ralph S. Good.

Percy Braunstein, 501 Madison Avenue,
With Alfred A. Knopf, Inc.

Daniel H. Breslow, 1450 Broadway,
With Michael H. Blum.

John R. Carbon, 521 Fifth Avenue,
With Loeb & Troper.

Charles Honoré Catelli, 67 Broad Street,
With Haskins & Sells.

Paul Jules Chenet, 21 West Street,
With Leslie, Banks & Co.

Franklin Herbert Constable, 50 Rockefeller Plaza,
With Rockefeller Center Inc.

Camillo D'Agostino, 21 West Street,
With Leslie, Banks & Co.

William Edmund Davies, 80 Broad Street,
With Clarke, Oakes and Greenwood.

Anthony de Benedetto, 36 Hudson Street,
With Wood & Selick, Inc.

Isidore Denemark, 30 East Liberty Street, Sumter, S. C.
With Boyle Road & Bridge Co., Inc.

Raymond E. Dolar, 80 Broad Street,
With General Telephone Service Corporation.

Albert Benjamin Doloff, 19 West 44th Street,
With Klein, Hinds and Finke.

Henry C. Elfers, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.

James Leon Epstein, 1501 Broadway,
With Louis Roth.

Charles Joseph Flynn, 105 Hudson Street, Jersey City, N. J.,
With Colgate-Palmolive-Peet Co.

Joseph Warren Fowler, 130 West 44th Street,
With The Lambs.

Osias Gang, 357 Fourth Avenue,
With William Iselin & Co., Inc.

Samuel Glazer, 521 Fifth Avenue,
With Trager, Berman and Keroes.

Meyer Greenberg, 215 Montague Street, Brooklyn.

Frederick R. Grochau, 80 Centre Street,
With N. Y. State, Dept. of Labor, State Insurance Fund Investigation.

Murray Gordon Gurentz, 116 John Street,
With Fire Companies' Adjustment Bureau, Inc.

Thomas H. Hanley, 366 Madison Avenue,
With F. R. Tripler & Co., Inc.

Julius Henig, 120 West 42nd Street,
With Max A. Posner.

Frank Leslie Hopkins, Jr., 50 Broadway,
With Webster, Horne & Blanchard.

Edward W. Ifland, 1270 Sixth Avenue,
With R. K. O. Service Corporation.

John J. Irvine, 67 Broad Street,
With Haskins & Sells.

Frank Judd, 1 South William Street,
With Lehman Corporation.

George O. Kahkonen, 90 Broad Street,
With Beard & Abney.

Henry Kaplowitz, 110 West 40th Street,
With Louis Kurzman.

Israel Klein, 213 Franklin Street.

Henry M. Koster, 60 East 42nd Street,
With Air Reduction Sales Company.

Maxwell Laskowitz, 1100 Grand Street, Brooklyn,
With Filtered Fuel Oil Corporation.

Norman Lewis, 11 West 42nd Street,
With Simonoff, Peyser & Citrin.

Oral Leon Luper, 1716 Rand Bldg., Buffalo,
With Price, Waterhouse & Co.

John Edward Manifold, R. C. A. Bldg.,
With American Cyanamid Co.

Vincent S. Martucci, 88 Lexington Avenue,
With Hecker Products Corp.

John P. Masterson, 220 East 21st Street,
With Pinaud Incorporated.

John Wylie McKee, 25 West 45th Street,
With W. C. Heaton & Co.

Paul S. Mirabito, 50 Lafayette Street,
With Dept. of Finance, City of New York.

Walter Scott Neustadter, 56 Pine Street,
With Price, Waterhouse & Co.

Florence Marie Nicit, 901 University Bldg., Syracuse,
With Maurice W. Powers.

Edwin Samuel Phillips, 268 Main Street, Buffalo,
With Metropolitan Commercial Corporation.

John B. Pisani, 137 West 24th Street,
With Dykes Lumber Company.

Patsy A. Pizza, 52 William Street,
With Crafts & Zirkle.

August John Pousson, 17 East 42nd Street,
With Quinn, Berran & Co.

Edward J. Powers, 80 Centre Street,
With State of New York, State Banking Dept.

Alfred Byron Reiss, 230 Park Avenue,
With Allen R. Smart & Company.

Samuel J. Rickles, 366 Broadway.

Ralph Rosenblatt, 321 West 44th Street.

Frederick H. Schmucker, 80 Centre Street,
With New York State, Dept. of Public Service.

Harvey Seelig, 1371-56th Street, Brooklyn.

David J. Silberman, 535 Fifth Avenue,
With H. J. & M. H. Behrman Company.

Fred H. Sirkin, 1440 Broadway,
With Freedman & Freedman.

Edmund Foster Smith, 103 Park Avenue,
With Davies & Davies.

Morris Harold Sturmer, 119 West 57th Street.

Victor Crawford Thaller, 111 Broadway,
With Scovell, Wellington & Co.

John L. Titus, 11 Broad Street,
With Chase National Bank, Bond and Mortgage Dept.

Harry Lee Van Arsdale, 20 Genesee Street, Auburn,
With Marshall Meadows & Stewart Inc.

Harcourt Cyril White, c/o Kings College Club, 501 West 121st Street.

Richard C. Whitelocke, 105 Hudson Street, Jersey City, N. J.,
With Colgate-Palmolive-Peet Company.

Robert Dunlop Whiteman, Jr., 56 Pine Street,
With Price, Waterhouse & Co.

Lauri E. Wickeri, 18 Pine Street,
With Chase National Bank, Credit Dept.

Theodore Leonard Wilkinson, 56 Pine Street,
With Price, Waterhouse & Co.

Elijah Benjamin Wright, 20 Exchange Place.

Solomon Zimmerman, State Office Bldg., Albany,
With State of New York, Income Tax Bureau.

Moses A. Zuckerman, 225 West 34th Street,
With Alexander M. Feld.

Advancement from Associate Membership to Membership

Sol B. Birkenfeld, 101 Cooper Street.

William A. Fischler, 250 Hudson Street,
With Board of Transportation, Bureau of Audits.

Herbert H. Gerken, 125 Park Avenue,
With S. D. Leidesdorf & Co.

Morris M. Goldberg, 1440 Broadway,
Of Goldberg & Haas.

William James Hanley, Lake Wales, Fla.
Comptroller, Mountain Lake Corporation.

Paul Harmel, 225 Lafayette Street.

Andrew J. Johnson, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.

Harry C. Kinderlehrer, 225 West 23rd Street.

Murray M. Kolker, 3 West 16th Street,
Of M. M. Kolker & Co.

Jerome Levande, 19 West 44th Street,
With Klein, Hinds & Finke.

Moses Asher Mach, 45 West 45th Street,
With J. B. Kass & Co.

Samuel Oser, 270 Broadway.

Sol Reiver, 80-02 Boulevard, Rockaway Beach.

Aubrey B. Stern, 62 West 26th Street.

Ralph W. Yoder, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.

Rubin Yoskowitz, 696 Willoughby Avenue, Brooklyn.

The number of members in the Society as of May 15, 1939 is as follows:

Members	2,950
Associate Members..	380
Total........	3,330

Municipal Accounting

The addresses which follow were presented at the eighth series of round-table discussions on the evening of May 25, 1938, at the Town Hall Club, under the direction of the Committee on Municipal Accounting of which Mr. William R. Donaldson was chairman.

Municipal acct. Government acct. List all papers

An Introduction to Municipal Accounting

By William R. Donaldson, C.P.A.

By way of introduction to our subject for discussion, it is interesting to know that our Committee has found that only a very few of the Society's members have had experience in the field of municipal accounting and auditing. Therefore, our topic is being approached from its simple and fundamental concepts, recognizing that even these will be brand-new to many of the audience and to those members not present who will read any publication that may grow out of this round table discussion.

The principles and practices of municipal accounting are necessarily of only comparatively recent development. In Colonial Days we were a vast agricultural area and had few of the problems now found in complex urban life. Where villages grew up some simple form of government with non-salaried officials came into being. But schools were privately operated; water came from a well behind each house; streets were unpaved and unswept; garbage was burned or went into a hole in the ground, the fire department was composed of volunteers. There were no police, subways, traffic problems, playgrounds, stadiums, art galleries —nor families on relief. Then followed the town and eventually the expanding cities. These local units of government owe their existence to the State and were formed under legislative authority. Their powers, privileges, scope and manner of organization and functioning were prescribed by state statute. While the village blacksmith could serve in his spare time as Village Clerk and collect and disburse the few dollars required to run his village's governmental affairs, now a City Comptroller or a City Treasurer with a large staff is needed to cover this phase of a large city's government.

To point out how far away from pure government the scope, tasks and problems of municipal government can grow and have grown, on the reverse side of New York City's 1938 tax bill we find the 1938 budget divided into several classifications. The total is 589 million dollars; roughly $81 per capita, and this does not include emergency relief financed by the sales taxes and the other emergency taxes levied for that specific purpose. Out of that $81 debt service (interest and retirement) takes $23. The operating budget is $58 per capita. Education gets $15 of it; $18 goes for health, sanitation, hospitals and public welfare (not including emergency relief) and $14 for police and fire protection. These total $47, leaving only $11 out of the $81 which in the broad sense is spent on governmental phases, as distinct from the service phases, of the municipality's operations.

Because of the rapid urban development throughout the United States, the demand of "town-folks"

for increased and complex services, and the fact that forty-eight State Legislatures had their hands in fixing the bases for organizing and operating the units of local government, it can readily be seen that municipal account-keeping became as diverse and ramified as the types of local governmental structure. Professor Lloyd Morey, in an article entitled "Progress Toward Accepted Principles in Municipal Accounting" (Journal of Accountancy, February 1937), said in his introduction:

"Until recently, there was a lack of agreement on fundamental principles, an absence of authoritative standards, and no reasonable uniformity in either procedure or terminology. Much of this has been due to the fact that municipal accounting is to a substantial degree controlled by state law. We have forty-eight different states, each of which has its own laws, sometimes several different laws in a single state, governing both the subject matter, the methods of statement and even the nomenclature of counties, cities, townships, villages, boroughs, parishes, school and other districts within each state. Often the laws themselves are supplemented by instructions, rulings, and decisions of some state authority or of some local authority which have a binding force on those who prepare, examine and report upon municipal accounts. Accountants, therefore, are not always free to follow their own best judgment and opinion with respect to accounting matters. If the law of a state or decisions under the authority of law define a particular term or state how particular accounts should be kept or how a municipal statement should be prepared, this will supersede any personal judgment of the accountant or any opinion of any group or committee of accountants."*

In 1933 there was formed the "National Committee on Municipal Accounting". It consisted of representatives of four national associations of accountants and teachers of accounting and five national associations of public officers and citizens, with the U. S. Bureau of the Census cooperating. After extended survey and research this Committee enunciated what it considered to be the Basic Principles of Municipal Accounting. In the Committee's publication "Municipal Accounting Statements" (August 1936) appear these principles, as follows:

1. The accounts should be centralized under the direction of one officer. He should be responsible for keeping or supervising all accounts and for preparing and issuing all financial reports.
2. The general accounting system should be on a double-entry basis, with a general ledger in which all financial transactions are recorded in detail or in summary. Additional subsidiary records should be kept where necessary.
3. The accounts should be classified in balanced fund groups. The group for each fund should include all accounts necessary to set forth its operation and condition. All financial statements should follow this classification.
4. A common terminology and classification should be used consistently through the budget, the accounts, and the financial reports.
5. The following classification of funds is recommended: (1) general, (2) special revenue, (3) working capital, (4) bond, (5) special assessment, (6) sinking, (7) trust and agency, (8) utility. Other funds may be established where specific activities require separate accounting. Cash, whose ultimate use has not been determined, may be included temporarily in the trust and agency funds or carried separately in suspense accounts.

6. A clear segregation should be made between the accounts relating to current assets, liabilities, and operations, and those relating to fixed assets and liabilities. Asset accounts for permanent property not available to meet expenditures or obligations should be segregated from other fund assets and the equity represented by them not included in the current surplus of any fund. Revenues should be classified by fund and source, and expenditures by fund, department, activity, character, and object, in accordance with standard classifications.
7. The general accounting system should include budgetary-control accounts for both revenues and expenditures.
8. As soon as purchase orders or contracts are signed, the resulting obligations should be entered at once as encumbrances of the funds and appropriations affected.
9. The use of the accrual basis in accounting for revenues and expenditures is recommended so far as practicable. Revenues, partially offset by allowances for estimated losses, should be taken into consideration when earned, even though not received in cash. Expenditures should be recorded as soon as liabilities are incurred.
10. Although depreciation on general municipal property may be omitted in the general accounts and reports, it should be considered in determining unit costs if a cost-accounting system is used.
11. The accounting for municipal business enterprises should follow the standard classifications employed by similar private enterprises. Each college, hospital, library, and other public institution should follow the standard classification applicable to its accounts.
12. Inventories of both consumable and permanent property should be kept in subsidiary records controlled by accounts in the general accounting system. The fixed-asset accounts should be maintained on the basis of original cost, or the estimated cost if the original cost is not available, or, in the case of gifts, the appraised value at the time received. The computation of depreciation on general municipal property is not recommended, except for unit-cost purposes, unless cash for replacements can legally be set aside.
13. There should be general uniformity in the financial reports of all municipalities of similar size and type.
14. Financial reports should be prepared monthly or oftener, to show the current condition of the budgetary accounts and other essential information. At least once each year a general financial report should be prepared and published or otherwise made available for public examinations.
15. A periodic audit by independent accountants is desirable.

Those who wish to go further into a study of these principles and the manner in which they find application in the several forms of local governmental structure will find several books and pamphlets available, products of the researches and conferences of the National Committee and of the Municipal Finance Officers Association. It is not our intention to expand on these principles at this time, but merely to point out that they have received unanimous acceptance throughout the country as affording the fundamentals upon which to build and operate

the accounts of a municipality and out of which flows the appropriate presentation of the financial affairs and the operations of the village, town, city, or whatever the unit may be called. As Mr. O'Brien and Mr. Hart develop their respective subjects the relationship to these principles will undoubtedly be observed in their comments.

Municipal Accounting in New Jersey

By A. M. Hart, C. P. A.

As a preliminary, a little of the history of the development of Municipal Accounting in New Jersey may prove interesting.

In 1918 there was established by act of the Legislature a Department of Municipal Accounts headed by a commissioner and supplied with a very limited appropriation. Mr. Walter R. Darby was appointed Commissioner of Municipal Accounts and certain powers and duties were prescribed for the office.

Among these were the establishment of a uniform system of accounts for Municipal Sinking Funds; institution of biennial audits of these Sinking Funds; the licensing of Municipal Accountants; the establishment of a form of audit for municipalities and counties; the prescription of forms for annual Debt Statements and Statements of Financial condition; limited powers of review over local budgets with the right to issue orders for inclusion of mandatory items when omitted; the duty of compiling State-wide statistics on municipal finances and the power to supplant auditors in municipalities where irregularities were discovered.

Legislation requiring annual audits by Registered Municipal Accountants of all municipalities and counties having assessed valuations over $3,000,000.00 was also enacted, together with a statute providing for the issuance of licenses annually to "competent and experienced auditors of municipal accounts". In the case of municipalities having assessed valuations of less than $3,000,000.00 the audits of two years could be made at one time.

In 1916 the Bond Act was rewritten and from that time no more term bonds were permitted, all new issues being serial as to maturities and in 1917 a Budget Act was placed upon the books.

Since 1918 many changes have occurred in the laws and there has been much elaboration and refinement of procedure. During intervening years a number of pamphlets have been issued among them "Requirements of Audit" and "Handbook for Municipal Officials". These have been revised so that at present current matter consists of a "Chart of Accounts" published in 1937, "Requirements of Audit 1938" and a new handbook which is in preparation. The Bond and Budget Acts have been completely rewritten and several other statutes enacted affecting municipal accounting and finance.

At the present time what was originally the Department of Municipal Accounts has become the Department of Local Government headed by Commissioner Darby with the title of Commissioner of Local Government and assisted by a four member group known as the Local Government Board. In the interval the Department of Municipal Accounts became the office of the State Auditor and had added to it the duty of auditing departments of the State government. With the establishment of the Department of Local

Government in 1938 all matters having to do with municipalities were carried into this Department together with the Commissioner and the personnel, reducing the functions of the office of the State Auditor to those indicated by the title.

A few years back the licensing of Registered Municipal Accountants was placed in the hands of the State Board of Public Accountants, the body which controls the issuance of the Certified Public Accountant certificates. Except for this change the powers and duties now vested in the Local Government Board, the Commissioner and the Department of Local Government are far more comprehensive than at any time since the movement for control of local finances was initiated. Notable among these are the power to require the installation of uniform systems for Municipal bookkeeping and the requirement that every local budget have the approval of the Commissioner of Local Government before it may be adopted by the local governing body.

The Registered Municipal Accountant in charge of an audit has with the local governing body practically the same relationship as he would have with a commercial client, with the added duty of filing a certified copy of his report with the Commissioner of Local Government. His responsibility is individual regardless of the fact that he may be either a member or an employee of a firm.

The requirements as to scope and the detail to be included in the report of audit are far broader than those generally deemed adequate for commercial examinations. The report, when in strict conformity with present requirements, provides a more complete and detailed picture of the financial condition of the municipality and of the operations for the year under review, than could be obtained from the general ledger itself, unless supplemented by numerous analyses.

Without going into a description of all of the steps necessary to produce the required result I will cite two points where State control is exercised. Bank confirmations are obtained on forms provided by the State the duplicate copies of which are forwarded directly to the Department of Local Government by the bank and beginning with 1938 it is a requirement that all outstanding taxes or other municipal charges be subjected to a test by direct confirmation of not less than 10% of the number of items and aggregating not less than 10% of the money value represented by the whole test. These confirmations are prepared on State forms by the auditor who transmits them in bulk to the Department of Local Government from whence they are mailed and to which they are returned; the bulk returns being turned over to the auditor periodically.

Basically the accounting falls into three major groups termed Current, Trust and Capital. In addition municipal utilities, formerly designated as sub-groups in the Trust Division, are now treated practically as independent units.

The Current Division deals with the accounting for the general budget and tax levy.

A budget is adopted annually and is accounted for by the simple process of debiting all anticipated revenues and crediting all appropriations. The tax levy is established by the County Board of Taxation which body adds together the requirements for strictly local purposes, local schools, state taxes and county taxes. The assessed valuations on which the tax rate is based are set by the local assessor and reviewed by the County Board of Taxation, which body officially sets the rate for each municipality in the County.

The appropriations in the general budget cover the costs of operating all municipal services, except those for which a charge is made, as well as all debt service except that for municipal enterprises, and appropriations necessary to meet any deficiencies in other divisions.

The Trust Division has as its major element special assessments for local improvements, with related indebtedness, and any special funds resulting from deposits by private interests for particular purposes. Maturing trust debt is provided for in the annual budget in what is known as the Dedicated Revenue Section and any difference between available Trust Revenues and the amount required is raised as a deficit in the general budget and anticipated as a revenue in the Dedicated Revenue Section.

The Capital Division covers the accounting for all improvement authorizations during the construction period, except municipal enterprises. Upon completion of an improvement which benefits particular properties the assessment is carried to the Trust Division. The costs of all improvements or equipment which constitute general benefits are closed upon completion to an account termed "Deferred Charges to Future Taxation" which account is balanced exactly by related indebtedness.

As the debt matures and is paid from general budget funds this account is reduced in proportion. While there is no objection to the maintenance of property and improvement accounts recording full costs, these accounts are never shown in a formal balance sheet, one reason being that such treatment would produce a surplus figure from which nothing liquid could be obtained.

Municipal enterprises such as water, electric or other utilities are kept in individual groups and a dedicated revenue section is placed in the annual budget for each, any deficit being covered by an appropriation in the general budget.

Full double entry procedure is required, with the general ledger either greatly detailed or condensed according to the extent and adequacy of the subsidiaries in use.

The largest volume of work is, of course, connected with the annual tax levy. Preliminary tax bills representing one-half of the amount of the previous year's tax are sent out in December and a final bill showing the actual amount for the current year, less the amount previously billed, is sent out usually in May. Both bills are split into two payments making an installment due on the first day of February, May, August and November. Real estate taxes remaining unpaid on July 1st following the year of levy are required to be advertised and sold. Such liens as are not bid in at the sale are taken over by the municipality and set up in an account called "Tax Title Liens", to which account subsequent taxes on the same properties are accumulated at the end of each year by journal transfers from the current tax duplicate. After two years from the date of sale the municipality may act to bar the right of redemption and become the owner of the property, which may then be sold at public sale. Personal property taxes are enforceable by distress and sale or arrest of the delinquent. The levying of poll taxes is optional and the majority of municipalities no longer impose this tax.

The governing body may remit personal and poll taxes, but its power with relation to real estate taxes is limited to correction of palpable errors. Real estate owners may appeal to the County Board of Taxation and State Board of Tax Appeals against assessments.

Each individual tax levy remains on the books until the last item is eliminated from the duplicate either

by collection, remission or tax sale, there being no authority to whom an uncollected balance may be turned back. The successor in office to the Tax Collector or Receiver of Taxes must continue to give attention to the prior year balances existing at the time he assumes office.

During recent years some special laws were enacted providing for funding of current obligations and carrying with them the obligation to adopt cash basis budgets. More recent legislation made the adoption of cash basis budgets mandatory for the majority of municipalities for 1939. This was then followed by some hasty enactments the effect of which is to postpone the mandatory feature for two years but to permit this type of budget where desired.

The major difference between a cash basis budget and the other type is that in the former collections of delinquent taxes are anticipated, using the percentage experience of the preceding year as the limit of anticipation, with the inclusion on the appropriation side of a provision termed "Reserve for Uncollected Taxes". This reserve is determined by assuming the amount of cash required from current taxes to balance the budget to be a percentage of the required levy not in excess of the percentage collected during the preceding year from the levy of that year. Where the amount allowable as an anticipation from delinquent tax collections is not less than the appropriation required for the reserve for uncollected taxes the transition to the cash basis works no hardships.

Miscellaneous revenues of the general budget and anticipated revenues of municipal enterprises are limited to amounts realized in cash from the same sources during the preceding year. Where evidence exists that these receipts will be greater or that revenue will be received from a source not listed in the preceding budget, submission of this evidence in resolution form to the Commissioner of Local Government will result in approval of the additional revenue as an anticipation if the Commissioner is satisfied that the item will be received.

There are many ramifications of all of the subjects discussed in this article, which is at best little better than an outline in which I have attempted to sketch the New Jersey picture in broad terms rather than to exhaust the details of any particular phase.

Laws and Regulations Dealing with Municipal Audits and Reports

By H. T. O'Brien

IN my discussion this evening, I do not intend to pose as an all around accountant, and if I should attempt to do so, I am very much afraid I should get into water much beyond my depth.

Municipal Accounting differs radically from commercial accounting in that the profit element is absent and we are not concerned with profit and loss accounts. We are interested, however, in revenues and expenditures. We undertake to control the expenditures and in the annual reports of the fiscal officers, we endeavor to show the results of a fiscal program and hope, though this hope is frequently shattered, that the result is a credit balance and not a deficit.

By Chapter 705 of the Laws of 1905 most of the municipalities in the state of New York were required to file annual reports with the state

comptroller and by the same statute the comptroller was required to cause the accounts of the fiscal officers of the municipal corporations to be inspected and examined by one or more examiners to be appointed by him.

This statute was amended by Chapter 215 of the Laws of 1907 and has since been incorporated in Article 3 of the Consolidated Laws known as the General Municipal Law.

Briefly this statute requires all of the municipalities in the state, except the counties within the city of New York and the cities of New York, Buffalo and Rochester annually to make a report of its financial condition to the comptroller.

These reports are required to be in the form prescribed by the comptroller and as the statute says—

" * * * shall contain:

1. A statement of the receipts of such municipality from all sources and of all accounts or revenue which may be due and uncollected at the close of the fiscal year.

2. A statement of the disbursements for all branches of the municipal government during the fiscal year.

3. A detailed statement of the indebtedness of the municipality at the close of the fiscal year, the provisions made for the payment thereof, together with the purposes for which it was incurred.

4. A statement of the costs of ownership and operation and of the income of each and every public service industry owned, maintained or operated by any such municipal corporation.

5. Such further or more specific information in relation to the cost of any branch of the municipal service or any improvement therein as may be required by the comptroller."

I am now referring to Article 3 of the General Municipal Law.

This statute, in addition to the foregoing, provides that the comptroller shall cause the accounts of all fiscal officers of each such municipal corporation to be inspected and examined by one or more examiners to be appointed by him at such periods as he shall deem necessary. On every such examination inquiry shall be made as to the financial condition and resources of the municipal corporation, and into the method and accuracy of its accounts.

Under the statute the comptroller is given power to appoint such examiners as shall be provided for by the annual appropriation bill.

These examiners "have power to examine into the financial affairs of every municipal corporation enumerated herein and to administer an oath to any person whose testimony may be required, on any such examination, and to compel the appearance and attendance of such person for the purpose of any such examination and investigation, and the production of books and papers.

I quote in full §36 of the statute under consideration.

"The comptroller may formulate and prescribe a system of keeping account, which system shall be uniform for each class of municipal corporations specified in section thirty of this chapter, and from time to time, whenever he shall deem it necessary, direct the instalment of such system by any one or more of the municipal corporations comprising such class. Any officer of such municipal corporation who shall refuse or wilfully neglect to comply with such direction of the comptroller within such reasonable time as the comptroller may prescribe shall be guilty of a misdemeanor. The comptroller, may, however, and upon good and sufficient cause shown shall, extend such pre-

scribed time as may be reasonable and necessary. The expense of installing a system of keeping accounts in pursuance of this section shall be paid out of such appropriation as shall be made to carry this article into effect."

There are now in New York State, subject to the financial supervision of the comptroller, 57 counties, 57 cities, 550 villages and 932 towns.

The chief fiscal officer of each of these municipal corporations is required to file an annual report in the office of the state comptroller upon forms furnished by him. These reports are verified for correctness, tabulated and the results printed in an annual report submitted to the legislature.

From time to time as opportunities permit our Examiners are commissioned to make examinations into the accounts and financial affairs of the municipalities.

Upon the completion of the examination or audit of a municipality, a report is written by one of the examiners. After transmission to the office it is edited and typed and immediately thereafter filed in the comptroller's office and in the office of the chief fiscal officer of the municipality.

In making these examinations or audits of the municipality the widest scope is allowed to the examiner and the extent of the field covered in each instance depends more or less upon the conditions which are disclosed and to some degree, perhaps, upon the idiosyncrasy of the examiners.

I entered the Bureau in 1907 during the incumbency of the Honorable Martin H. Glynn, and since I have remained in that Bureau since its inception, I have witnessed all the steps taken by the various incumbents of the comptrollership, looking toward an improvement in the accounting methods of municipal officers.

In 1912, when Mr. William Sohmer was Comptroller, two of our examiners prepared a system of accounts for those cities which at that time were known as cities of the second class.

One of these gentlemen, Mr. John J. Magilton, is now the chief auditor in the Comptroller's Office, a certified public accountant, and a member of your society.

In 1917, under the direction of Comptroller Travis, we prepared and the Comptroller promulgated a system of accounts, accompanied by a proposed budget, for cities of the third class.

In 1920, again under the direction of Comptroller Travis, we prepared and the Comptroller promulgated a system of accounts accompanied by a proposed budget for the counties in the state.

In 1925, under the direction of Comptroller Murphy, we prepared a system of accounts for villages which included therein a proposed form of budget adapted to the requirements of the village law as it was then written.

We have also prepared a system of accounts for towns which consists of nothing more than a cash book and ledger. The cash book is intended to be a complete record of incoming and outgoing cash and the ledger provides segregation by funds with a classification account which enables the supervisor to prepare his annual report with as little difficulty as possible.

In our efforts to install our accounting systems we have rarely met with any continued opposition and now practically all of the cities in the state are following our plans, or plans so closely akin thereto, as, well to say the least, to make them first cousins.

We have not been entirely successful in counties principally be-

cause of the fact that clerks of boards of supervisors are not, as a rule, full time officers and because the best time to revise a county budget, the foundation of an accounting plan in the treasurer's office, is at that time of the year when the clerk's duties are most onerous, even without the additional labor of learning something new.

We have also been handicapped by the lack of sufficient examiners to enable us to do all the work which the law imposes upon us.

In 1908, we had 15 examiners. In 1938 the number amounts to 30 field men.

The systems of accounts formulated and prescribed for cities and counties are in outline substantially the same.

In these systems the accounts are grouped in four classes, namely—

Current Accounts
Capital Accounts
Assessment Accounts, and
Trust Accounts

The current accounts include all those accounts which reflect current revenues and current expenditures, and which in the main, are controlled by a budget.

Capital accounts are those which are, as a rule financed by bond issues, or in some cases by taxes, and which result in an increase in an asset account known as the property account.

Assessment accounts embrace transactions which are financed by means of special assessments against property benefited.

The trust accounts include those accounts in which the municipality has no beneficial interest, and in which the municipality acts merely as a trustee.

The classification of current expenses is two-fold:

(1) By governmental functions.
(2) By object of expenditure.

The classification by functions is somewhat arbitrary following generally that which is used by the United States Census Department in compiling statistics for cities.

In counties, in the classification by objects of expenditures, four standard accounts are provided as follows:

(a) Salaries, wages and fees.
(b) Purchase of equipment.
(c) Materials and supplies.
(d) Expenses.

In cities, the classification is more detailed running, for example, about as follows:

(a) Salaries and wages.
(b) Traveling expenses.
(c) Office expenses.
(d) Printing and advertising.
(e) Purchase of equipment.
(f) Maintenance of equipment.
(g) Materials and supplies.
(h) Repairs.
(i) Light, heat and power.
(j) Rent.
(k) Insurance.

We have succeeded in establishing these systems in all of the cities in the State, except New York, Buffalo and Rochester, and in about two-thirds of the counties.

We have never had a force of men sufficient to comply with all of the requirements of the statute and hence we have gone ahead and have done the best we could do under the circumstances.

During the past ten years, every municipality in the State which is required to report to the Comptroller has complied with the law; with the result that reliable information has been tabulated which shows a complete statement of all moneys received and expended by the municipalities over which the State Comptroller exercises supervision.

Moreover, the reports now received show very great improve-

ment over the reports of former years.

While assistance was formerly required in many instances by the local officers, the efficiency of these officers has increased to such an extent that little or no difficulty is now experienced in obtaining satisfactory and accurate reports, and, I believe, that the systems of accounts formulated and prescribed by the Comptroller, have contributed to this accuracy in no small degree.

In the pursuit of our duties, we have endeavored to be not only supervisory and correctional but educational as well, and this feature of our work is much more agreeable than criticism, faultfinding, disclosing illegalities or, as sometimes happens, exposing violations of the penal law.

In a recent fiscal year, our examinations resulted in the recovery to municipalities of considerably more than a half million dollars.

In one town a venal contractor returned to the town about $600,000.00, and in a county a group of officials repaid about $11,000.00.

These are not features of our work from which we derive any pleasure. But since human nature is what it is, there will always be some who will take advantage of opportunities for peculation, and, when we find these things in the course of our labors, we can do none other than expose the wrong-doer without fear or favor.

The educational value of our work should not be overlooked. As practical men and women, you know that under the party system prevailing in these United States, tenure of office is uncertain. New men need training and this, in very many instances, we have been able to supply.

A man or a group of men elected by the people for a term of years has no assurance that one good term will deserve another.

And so it sometimes happens in a municipality that the entire organization owing allegiance to one of the political parties finds itself evicted to be succeeded by another group belonging to the opposition.

I know that such methods are wasteful and not conducive to the best results in government, but, nevertheless, our form of government is still more or less influenced by the belief that to the victors belong the spoils.

New men need coaching and we, in our Bureau, are always ready and willing to supply help and assistance when so requested.

In my opinion the correct foundation for any system of municipal accounts is a budget.

Mr. William E. Gladstone, England's grand old man, once said—

> "Budgets are not merely affairs of arithmetic, but in a thousand ways go to the root of prosperity of individuals, the relation of classes, and the strength of kingdoms."

This statement, as a certain text writer says, epitomizes the significance of the budget and the importance of budget making in government.

I cannot tell who framed the next definition I am going to give you, but it has been current with us for so many years that my right to use it is protected by the doctrine known as "prescriptive right" and any possible danger of a charge of plagiarism is precluded by the status of limitations. Hence, I give it to you as I first saw it years ago and without the use of inserted commas—

> A municipal budget is the formal, complete, final statement of the proposed financial plan for a fiscal period, comprising the authorized municipal expenditures for that period correlated with the estimated revenues and other means of meeting such expenditures.

A generation ago, no attempt had been made to apply budget methods and procedure to American city governments. In those days city authorities were spending thousands, even millions, of dollars annually with little or no thought as to where the money was coming from or what they were getting for it. Often the expenditures and the income of the government did not balance. Some city departments received too much; others were starved from lack of funds. Frequently money was borrowed to meet current bills and the obligation of payment passed on to the next generation in the form of long term bonds.

But things have changed. Today practically every progressive city government in the country has established a budget procedure of some kind. In many cases, however, this procedure is not very effective, owing to the form of administrative organization or to the relation that exists between the city executive and the legislative body. But the present trend in the development of municipal organization points toward the gradual elimination of most of the difficulties that now stand in the way of a comprehensive and workable budget procedure.

If the form of the budget follows the classification of expenditures to which I have already referred, the accountant then automatically has a segregation of expense items which harmonizes with his annual report and thus eliminates the necessity for a reclassification at the close of a fiscal period.

A capable municipal accountant should have some training in the law. He should know something of the Constitution, of the General Municipal Law, of the General City Law, of the Second Class Cities Law, of the Town Law, and of the Village Law. He should be able to distinguish between claims which are legal claims against a municipality and claims which are not legal. He should examine bond issues and be sure that these have been issued within the scope of the powers of the municipality.

More than all this, he should possess the milk of human kindness and in his dealings with public officials remember that all men are fallible and prone to make mistakes. When these are found be patient taking the official into your confidence and remember that more is to be gained by diplomacy than by tart and, perhaps, painful criticisms.

In conclusion, I must confess that twenty-five years ago I felt some misgivings about the entrance of public accountants in the municipal field. However, time has changed my point of view and now with grey hairs and, perhaps, a more charitable disposition I welcome you to our specialty.

If at any time in the course of your professional activity you encounter problems which are new and, perhaps, difficult, you may be assured of whatever assistance we may be able to render to you if and when you ask for it.

Discussion on Municipal Accounting

Questions Directed to Mr. Hart

From the Floor: Regarding the bidding for municipal audits, that is a very serious thing to the certified public accountant. Can you touch upon that?

Mr. Hart: May I answer as far as my own practice in New Jersey is concerned and that of a number of other men with whom I am acquainted? I have not, myself, made

a bid in a good many years. The nearest thing to a bid that I have made in recent years has simply been an informal statement as to what I thought the audit was worth, and by the time I reached that particular point I was the only candidate left in the field after the eliminating process had been gone through by this governing body.

We have an association of municipal accountants and we are trying to make bids a thing of the past, and ethical practitioners do not attempt to promote interest in themselves or foster the sealed bid proposition. I know that it is definitely being frowned upon and none of us who have municipal practices of any kind go in for it or like to see anybody else go into it.

From the Floor: Do you have standardized and required account classifications in New Jersey?

Mr. Hart: The State Auditor's office, in the last couple of years, has done a tremendous amount of work toward standardizing and classifying the accounts and the bookkeeping procedure relating to them, and a recently published pamphlet called the "Chart of Accounts" is more or less of a list of the account names encountered in the various divisions, with model journal entries in blank for most of the transactions which will be required in the new set-up. That is to be followed shortly by a handbook adapted as nearly as possible to the capabilities and experience of the average small-town treasurer.

A further section will come later on which will be a revision of the requirements of audit. This will be arranged in a sequence which can be used as a basis for developing a program before entering on an engagement. So by the time those other two sections are added we will have in New Jersey fairly comprehensive literature on the subject.

From the Floor: Did I understand Mr. Hart to say there is no legal requirement to ask for a bid by an independent auditor in New Jersey? There are such requirements in some states. I believe in California, in counties, both the prosecutor and grand jury have something to do with the selection of the auditor, and candidates have to appear and be subjected to an examination as to their standards and ethics and then they have to file bids and then the prosecutor, with the advice and consent of the grand jury, I think, engages the auditor.

Mr. Hart: There is no such requirement. In New Jersey that has been up in the courts. The New Jersey Supreme Court has held that the $1,000 bidding limit is not applicable to audits. It is held comparable to the engagement of professional, legal or medical talents and is not to be confused with the ordinary engagement of labor or the purchase of material.

From the Floor: Mr. Hart, what proportion of replies do you get from your confirmation of tax arrears?

Mr. Hart: It all depends on the population of the town and whether you happen to get something "hot". If it is routine you get a percentage somewhere in the low twenties.

You run into some rather weird things in connection with it. For instance, months after you close your report and have decided you have got back all the replies you are going to get, you will get in a circular on which is written "incorrect" with no explanation—"incorrect—this has been paid". You "hot-foot" it out to the town hall and look up the books and find it was paid the day before it was returned to you. The taxpayer holds it back until he is able to pay and then "shoots" it in.

From the Floor: Does the New Jersey law permit accountants to practice from outside the state?

Mr. Hart: If they are able to obtain the R. M. A. license by examination it does not matter where they come from. There are a number of New York practitioners practicing in New Jersey today. The chairman of our New Jersey Committee on Municipal Accounts, while he lives in New Jersey as I do, is with a large Philadelphia firm.

From the Floor: But if he neither lives nor practices in New Jersey?

Mr. Hart: The law states that he shall be a competent and experienced auditor of public accounts and be familiar with the laws of New Jersey governing municipal accounts and finance. Of course now, since the licensing is in the hands of the State Board rather than the State Auditor, the State Board puts an applicant for the R. M. A. license through the same course as the candidate for the C. P. A. has to go through. In other words, he has to appear before a character committee. In New Jersey there is a separate one for each county and an R. M. A. candidate has to go before it and shape up on the character side of it before he can get a license. In other words, a man from New Jersey or another state could not simply walk into the State Board's office and sit for the examination unless he could show some experience under a licensed R. M. A.

From the Floor: Does the R. M. A. law of New Jersey require that a fee be paid to the state?

Mr. Hart: Five dollars a year for the renewal of the license. If he is a new man going through he takes the R. M. A. examination and he has got to qualify. It is not automatic through his having passed a C. P. A. examination before.

From the Floor: What do you find collectors do with receipts in advance of getting the duplicate certified by the county board?

Mr. Hart: Well, what we try to work out in most cases is this: Get hold of the duplicate, which should be prepared at that time and awaiting transmittal to the County Board and post receipts for early payment right on it, then he will have a small gap while the duplicate is being certified by the County Board. He will simply have to pick up those back postings from his cash book. There is really no sense nor good in attempting to post them anywhere other than on the duplicate.

From the Floor: I have seen them post it to last year's duplicate.

Mr. Hart: I have also seen them do that, but it only makes double postings.

From the Floor: What is the usual procedure of handling over-payments on current year's taxes?

Mr. Hart: As a matter of practice, the auditor gets in on those "before the last show is over". In balancing the tax duplicates we get the over-payments, and are required to list them in detail in the audit report and you see to it that that amount is transferred on the controls by adding back to the tax account and crediting a liability account for over-payment. The actual effect of this entry is to reduce the cash credit to taxes and transfer that back to the over-payment account.

From the Floor: How would you say New York and New Jersey requirements vary?

Mr. Hart: I think one of the major points of difference is that in New York set-up the bookkeeping requirements are boiled down to the simplest of cash records, and in New Jersey each local treasurer or chief finance officer is supposed to keep a complete set of books, including a ledger and a journal, because when the budget is submitted to Trenton, financial data for the year just ended must be filed with it and that is

greatly facilitated by maintenance of general books with proper subsidiaries.

Mr. O'Brien stressed the simplicity of the accounts in the smaller units, but our double-entry system in New Jersey runs down to the very small ones.

Mr. O'Brien: Bear in mind there are 930 towns in New York State. The chief fiscal officer of the town is the supervisor, who is elected for two years. He may stay two and he may stay twenty, but all they are expected to do is to keep a record of the cash which comes in to them and pay bills which come in from the town auditors, but in the cities and the counties it is on an accrual basis with a double-entry set of books.

Leaving out the miscellaneous revenues, the only revenue which a city or a county will have is the tax levies. The expenditures (not the disbursements) are set up on an accrual basis if we can get them to use what we know as the "order system", which is a method prescribed in some instances by charter. It is in use by the second-class cities and is quite generally followed. A commitment is made against the appropriation, the order is returned to the purchaser, it comes back again in the form of an invoice, then the commitment is cancelled and the invoice takes its place.

The Department of Education has a single-entry cash book system of its own.

Mr. Hart: In New Jersey they have inspectors who make inspections and not audits. Some of the school districts do employ C. P. A.'s or R. M. A.'s to make audits just the same, and our New Jersey committee is trying more or less to get together with the state authorities in the school end toward a little lessening of tension between them and toward encouraging the school systems to engage independent auditors.

Mr. O'Brien: In New York State I think they have only four or five inspectors who run around through the districts but when they get in a tight place the Commissioner telephones over to the Bureau of Municipal Accounts and we work it out. Our law does not give us any jurisdiction over school districts except they have a population of over five thousand.

From the Floor: Where a certain department or a town enters into a contract, do they at once record the liability?

Mr. Hart: In school districts it is supposed to be done with everything. In municipalities it is usually done on contracts and a few municipalities have gone in for complete booking of commitments.

From the Floor: Did you find that the City of New York ever kept inventories?

Chairman Donaldson: In some departments they did. They kept them not so much a part of a control account until four years ago when the Central Department of Purchase was set up. Four years ago the Department of Purchase was created by a statute amending the charter and that department now has warehouses located all over the city, maintains stores accounts out of a revolving purchase fund and issues materials against requisitions. Before the Central Purchase Department was created, if the Fire Department bought a lot of rubber tires for Ford cars and the Police Department did, they would keep separate stocks. Now all stocks are purchased by and are under the Purchase Department control. Various departments make requisitions and charges are made to them through the Comptroller's office where the costs are charged against their respective allowances.

From the Floor: Mr. Donaldson, has the National Committee on Municipal Accounting been successful in having many of the municipalities adopt its principles.

Chairman Donaldson: Oh yes; all over the country revision in accounts is being made to conform to these principles.

From the Floor: Will you explain again how you treat the asset account represented contra by bonds issued for capital additions?

Mr. Hart: This is simply a way of bookkeeping. The improvement value on the books is diminished as the bonds go down. The general control account representing all those capital values is termed "Deferred Charges to Future Taxation" on the theory that those bonds are charges against future taxation. In other words, it is to express the obligation to raise taxes to pay those bonds when, and as they mature.

When the bond issue is completely retired for a given improvement it is perfectly proper, under the Jersey procedure to have the offsetting asset extinguished.

We do not carry a capital surplus representing debt retired on a big project as an active account. You may carry it as a memo account, simply keeping track of it for insurance purposes.

From the Floor: Mr. Hart, how do you treat serial assessments receivable in New Jersey?

Mr. Hart: As a trust asset.

From the Floor: Do they make it a practice to apply the penalties thereon to the assessment debt?

Mr. Hart: No, the penalties are general revenue always no matter what they are on, except in the case of utility penalties.

From the Floor: We have heard about accrual basis and cash basis. Is not it true that a lot of places have a combination of the two? I have heard of cases where you have them on the cash basis and then, at the end of the year, you accrue all your obligations.

Mr. Hart: I think I know what you have in mind. In New Jersey, miscellaneous revenues are definitely on a cash basis in that no more may be anticipated in this year's budget from franchise taxes, for instance, than was received from that source in the preceding year, and if it is an item that legitimately called for an accrual, that is covered by debiting a receivable and crediting a reserve for whatever the asset is only actual cash being credited to revenue. All municipally owned utilities, water or electric plants, are also on a cash basis. The taxes are set up on an accrual basis. Expenditures, so far as they represent commitments not met by cash payment at the end of the year, are accrued.

I do not agree with the proposition that the accrual of unpaid bills at the end of the year is a departure from a cash basis. It is an earmarking of the cash which you have to express—something which has to come out of it. Of course we have the other municipalities that issue refunding bonds for current purposes here under the 1934 law, and they are on a full cash basis; even the anticipated taxes in the budget are in anticipation of cash from that levy rather than the amount of the levy itself. If they collected seventy-five per cent of last year taxes their cash requirements for the next year are divided by seventy-five per cent and the tax levy is the answer. That brings about a cash basis of operations for actual tax collections, the same as everything else.

Questions Directed to Mr. O'Brien

From the Floor: Mr. O'Brien, how often do your examiners get to the various municipalities?

Mr. O'Brien: Not very often. I suppose the smallest municipality in the state will take two weeks to examine. A city will take from three to six months; a county will take three months. The villages will vary according to size; to some we don't get around very often. When a man's job is finished in one place, if we have a request from somebody else, he is sent there; if he isn't, Mr. Haner (my assistant) and myself send him where we feel like it.

From the Floor: There is no provision at all for audits by outside accountants, is there, like there is in the state of New Jersey?

Mr. O'Brien: No, no mandatory provision. If the municipality makes provision in its budget to employ auditors, it may do so.

From the Floor: About how many municipalities have independent audits?

Mr. O'Brien: I don't know. Not very many. Some two years ago the Mayors' Conference prepared a booklet on individual audits and I have not seen that in two years and I can't tell you. Not very many; out of the fifteen hundred, not ten per cent of them.

From the Floor: Is there any instance where an independent outside auditor is engaged for the filing of the report with the state comptroller?

Mr. O'Brien: It is a matter of courtesy only. I don't recall that I have ever seen a report by an independent auditor. Some of these large villages like Bronxville and Garden City are very proud of their reports. I get copies of those.

From the Floor: Mr. O'Brien, I presume you have a program of audit for your standardized examination?

Mr. O'Brien: No.

From the Floor: What I had in mind, for example, is what steps you take to assure yourself that the taxes which have been levied have been collected.

Mr. O'Brien: There is a real definite method of verifying the correctness of taxes. As Mr. Donaldson told you, the fiscal officer gets the information as to the total of that roll which, for round numbers, we will say is $1,000,000. In counties these rolls are given to the town tax collectors who go out and sit for a certain period and collect what they can. They settle with the supervisor and pay the supervisor on settlement day, which is ordinarily the first day of February, although the time may be extended until the first of June, but there comes a time, nevertheless, when the town collector comes into the county treasurer's office and he presents his warrant and his receipts for the money paid to the supervisor and the account is balanced off with cash and returned taxes.

I did not put my figure high enough there; $1,000,000 won't do, but I will go on.

That single account is in balance and the treasurer (in the county, I'm talking about now) has $5,000 which is called "returned real taxes." He debits that with the $5,000 and during the months of February, March, April, May, June and July up to the first of August, delinquents come in and pay those taxes with interest at a rate of ten per cent per annum.

We will say $2,500 has been collected from those delinquent taxes; he still has $2,500 to account for from county treasurers holding their

tax sales within the fiscal year which ended on October 31st, except in three counties in New York State. The $2,500 item then is transferred to the tax sale account and on the day of the tax sale he gets $1,250 from the sales of the county.

During the depression, county treasurers thought it would be a nice thing to favor tax-payers and they got away from our control, so I recall that in Albany County they moved the tax sale down to January and the young man in the office came in and saw me the other day and said, "We are going to get normal and I wonder if we can have a single sale." I don't like that business of running over the "tail" end of the fiscal year with the tax account because the figures are apt to get mixed up with the new tax collector. It was a nice scheme where counties were holding their sales before the close of the year, where everything was clear and all you had to deal with was tangible assets.

From the Floor: Do your examiners check that tax sale list?

Mr. O'Brien: Absolutely. They go to the tax sale list and see that every item is included there and which taxes are not paid.

Clothing Manufacturing Accounting

UNDER the direction of Mr. Michael Peyser, Chairman of the Committee on Clothing Manufacturing Accounting, the following interesting papers were presented at the fifth meeting of round-table forums held at the Hotel Woodstock, 127 West 43rd Street, New York City, on November 30, 1938.

Ladies' Coats and Suits

1st paper

By GEORGE N. JANIS, C.P.A.

Every owner of a cloak and suit business believes that he is running his affairs very carefully, but he is surprised when he gets the actual results. He wonders "Where have my profits gone," and he really believes that the profits he forecasted ought to be in his kind of business. An analysis will show him that vital elements in his calculations were omitted, and that he did not visualize other factors besides "sales" volume.

Coats and suits are fabricated in one of three ways:

1. Entirely in directly owned factories.

2. Entirely under contract with outside factories.

3. Partly indirectly owned factories and partly under contract.

No matter under what method the business functions, the accounting system must be devised to disclose waste, provide timely reports on progress or failure, and to accumulate and analyze all data on every feature of the business. The manufacturers make up garments consisting of many styles, fabrics and price ranges. This factor alone makes the industry very risky and requires very close watching and careful calculation. Then again, the weather is another force that must be reckoned with.

If the contractor makes up the entire garment, the manufacturer sends him cloth, linings, trimmings (such as buttons, zippers, ornaments and furs.) The manufacturer supplies the contractor, therefore, with all the material that goes into the finished garment. The contractor must return to the manufacturer completed garments. The accounting of these transactions must be carefully compiled so that nothing will be "lost in the shuffle."

The raw material is shipped to the contractor "on consignment," and at no time does title to the property pass to the contractor. The merchandise shipped to the contractor must not be handled as a sale upon the books of the manufacturer. The general ledger of the manufacturer should have the following accounts for the purpose of controlling this phase of the business:

1. Merchandise shipped to contractors. (If there are many contractors, an individual ledger account can be kept for each contractor.)

2. Labor rendered by contractors. (An individual ledger account may be kept if there are many contractors.)

3. Contractors accounts payable. (The individual accounts may be kept in a subsidiary ledger, as explained above.)

The contractor, on the other hand, will have the accounts reflecting the transactions as follows:

1. Merchandise received from manufacturer (mention name.)

2. Labor rendered manufacturers.

3. Manufacturers' accounts receivable.

As a rule, contractors do work for a few manufacturers, therefore no subsidiary ledgers are necessary. The entire transactions can be recorded in the general ledger; however, if shipments to the contractor are sent upon "memo" bills, then the accounting for the merchandise will be kept in yardages or under unit control. The contractor will likewise maintain a unit control record, and bill the manufacturer only for the actual labor performed. The manufacturer can control his stock at the contractor's by frequent inventories, say weekly. This method eliminates a great deal of bookkeeping, and under proper supervision leads to better results.

If the dollar control is adopted the manufacturer bills the contractor for material delivered to the latter. For illustration, the manufacturer sends the contractor raw material amounting to $500. The entry on the books of the manufacturer would be:

Debit—Contractor	$500.00	
Credit—Merchandise shipped contractor.....		$500.00

When the lot is completed, the manufacturer receives a bill from the contractor for the merchandise, $500, plus, say, $50 for labor. Then the next entry on the books of the manufacturer would be:

Debit—Merchandise shipped contractor.....	$500.00	
Debit—Labor rendered by contractor.........	50.00	
Credit—Contractor......		$550.00

Thus the manufacturer owes the contractor $50 for labor which is reflected in his account.

The contractors' books have opposite entries to the above. The use of the unit control of merchandise in place of dollar value eliminates a great many errors and reduces expense on account of clerical work.

Calculation Book

A cloak and suit business may seem very simple to the outsider, but the details are so complicated that only through proper accounting control can the business be made profitable. A calculation book of all styles must be kept. As stated previously, styles are constantly changing, and volume fluctuates. Then again, each manufacturer wants to make his line a real "leader," so he complicates the manufacturing by making up different designs at prices to meet competition. Here's where the accountant must devise a simple cost system. Excessive costs must be reduced and all elements making up the cost of the garment should be taken into consideration.

The calculation book should have the cost of each style besides a description of the garment and the selling price. The form can be made up to meet one's requirements, but should have the following information:

Material Cost

Piece Goods—yds. @	....
Linings —yds. @	....
Furs (it any) .....@	....
Trimmings ....@	....
Total Material Cost	....

Direct Labor & Expense

Direct Labor	....
Factory Expense	....
Social Security & Unemployment Tax	....
Total Direct Labor & Expense	....
Total Material, Direct Labor & Factory Expense	....
Add 10% of Material Cost for sponging, shrinkage, losses on account of defects in materials and "invisible" material losses	....

Selling Expenses Delivery Expenses Administrative Expenses	To be determined at % of sales
Discounts at 8% of selling price	....
Total Cost	....
Estimated 5% Profit of selling price	....
Selling Price	....

If, on the other hand, the calculation book shows only the cost of material, labor and factory expenses, and the overhead expenses of selling, delivery and administration expenses are not figured for each garment, then the accountant can readily determine if the per cent of gross gain is sufficient. In other words, let us say the manufacturer wants to make up a garment to sell for $16.75 and he wants 15% gross. The price to the customer is $16.75, less 8%, or $15.41 net. Expressed in statement form, the calculation will be as follows:

Gross Selling Price....	$16.75	—100%
8% Discount..........	1.34	— 8%
Net Selling Price....	$15.41	— 92%
Cost of Material, Labor and Factory Expenses	$12.90	— 77%
Gross Gain at 15%	$ 2.51	— 15%

If the overhead expense, based upon past experience, is 11% then his net gain will be 4% of selling price, or 67 cents on each garment sold of that price and style. At this rate of 4% a certain volume of business must be done in order to break even. Let us say that a manufacturer expects to do $30,000 in a month of a $16.75 line. He wants to know what he should pay for the garment in material and labor, and he wants to make 3% on net amount received on each sale. The answer would be as follows:

Regular Selling Price........	$16.75
Less 8% discount............	1.34
Net Price	$15.41

In order to do $30,000 gross, he must ship out about 1,790 coats. Net sales proceeds on 1,790 coats at $15.41= $27,583.90.

Expenses for month	$3,300.00	
Allowances, taxes, etc.—1%	275.83	
Profit of 3% of $27,583.90	827.52	3,403.35
Balance allowed for Cost of Material & Labor		$24,180.55
Average Allowance for Cost is $24,180.55 divided by 1,790 coats, or approximately		$13.50

The above method can be used to determine the monthly estimate of results and the actual figures can be obtained at the end of month. The comparison will serve as a guide in the correction of errors in forecasting.

Inventory Control

A standard control of material cannot be submitted in this paper because such control depends upon the management and policies of each organization. However, a strict control of all piece goods, linings, furs, trimmings, as well as finished products, should be kept. If no such control is undertaken the resultant loss may mean the failure of an otherwise profitable venture. Furthermore, through the use of a proper control many mistakes in buying piece goods will be readily brought to light, and an analysis of the price line will indicate the best ranges. In many cases, three to five price lines account for 90% of the business. The other 10% covers slow and expensive merchandise. The profitable merchandise must therefore carry the burden of markdowns of the slow movers. Besides, over-production, which frequently occurs, leads to destruction. An established price line with the correct volume of production for stock will often spell out in profits. Volume in itself never brings profitable

results. That is a lesson many coat and suit executives must learn. Unit profit is the determining factor.

It is a very difficult task to keep a complete stock record of all finished garments especially if they are shipped according to orders. However, the quantity cut and finished for each style should be recorded, to determine that the proper finished stock is returned by the factories or contractors.

A control of fur-trimmed garments should be carefully maintained, as these garments are high priced. As soon as furs are purchased, a register number should be assigned to each item. The tag attached to the fur should have five perforated parts. One is detached and submitted with the bill from the furrier. The second part is detached when the fur is sent to the factory. The third part is torn off when the factory receives it. The fourth part is torn off when the completed garment with the fur collar and fur trimmings reaches the coat-and-suit manufacturer. The fifth part remains on the fur-trimmed coat until it is shipped out to the customer. Each perforated part is sent to the stock clerk who handles these records. In this way a fur-trimmed garment is under control from the time the collar is bought to the time the garment is shipped to the customer. Returns of garments or furs can be controlled the same way.

Piece goods, on the other hand, must have complete supervision. Each piece of goods should be registered, and a tag with a seal should be attached to it. This tag cannot be removed until the piece has been consumed. Amount of consumed yardages should be recorded on the tag as well as on a daily report, showing what goods were cut. The number of garments produced from each piece should be reported, showing style manufactured, etc. In this way a record of production for all piece goods can be had and checked with incoming merchandise.

The goods sent to the sponger should be controlled as to return from sponger and amount of shrinkage. This shrinkage is a very important item and is often overlooked by the manufacturer. A piece usually shrinks about one to two yards and this shrinkage should be accounted for in calculating the cost of a garment. Any shrinkage over two yards should be reported and a claim obtained from the mill. This is very important, because the amount of shrinkage, if not watched, will eat into the profits and may mean a loss instead.

Under this heading the buyer of piece goods, linings, furs and other trimmings should have available information to determine how much to buy. Overbuying is worse than underbuying. Overbuying leads to losses that could have been prevented if the merchandise purchases were properly planned. Of course the best plan sometimes goes wrong, but careful forecasting based upon orders and capital profitably employed, will hit more often. Without planning, working by a "hit miss" method, a business would be ruined unless luck played with you. The old adage that luck is a lazy man's excuse for success applies to a cloak-and-suit man as well as to others. How to budget purchases is very simple: Estimate, according to orders or past results, how much business you expect to do in sport coats, dress coats and suits, according to price range. Determine the quantity you expect to sell in each group and price range. Quantity of garments to be sold, times price range, equals the volume for each group. Quantity of garments to be sold, times yardage used for each garment, gives you the yards required. The total yards required, times the average price-

per-yard of cloth, gives you the total investment in piece goods. The same method may be used for the other raw material. Do not buy raw material in excess of sales level. Purchases should be made from month to month, if possible, because of the influence of weather conditions, change of style, and other factors beyond one's control. A watchful policy will put a manufacturer in a liquid position at the end of a season.

A few words about inventory valuation. It is a good rule that an accountant should supervise the physical inventory. Unless that is done, it will be impossible to have a true picture of the inventory valuation. The inventory must be analyzed. This may be done with a simple columnar inventory sheet which records stock on hand according to piece goods bought during the current season, preceding seasons, and piece goods over a year old. In this way, a depreciated valuation can be readily determined. Furs should be segregated as to season and price, whether it is in a rising or falling market. Furs on hand at the end of a fall or winter season which are not to be used until the following fall or winter should be so stated and marked down accordingly.

The value of finished goods is subject to the influence of styles, and if any finished goods are on hand that cannot be disposed of until a later season, they should be cut to the bone. There is no use valuating finished goods at end of a season at more than a "forced sale" valuation.

Financial Control and Planning for Profits

The problems of a coat and suit business, aside from the manufacturing end, lie in the financial control. It is very easy to dissipate capital and profits. It requires a strong grip to preserve the capital structure. This is true of all types of business, but due to the seasonal nature of the cloak and suit business and the heavy risks involved, the liquid position must be carefully safeguarded. A chart should be prepared at the beginning of each season, showing the following information. I will take one month as an illustration, but the same method can be pursued for months in advance:

Accounts Receivable at beginning of month (net)	$12,000.00
Sales (net)	11,500.00
Total	$23,500.00
Accounts Receivable at end of month	$20,000.00
Collections	3,500.00
Cash on Hand	10,000.00
Total Cash Available	$13,500.00
Manufacturing Costs:	
Material	$ 5,000.00
Labor	1,000.00
Expenses—Factory	1,000.00
Total	$ 7,000.00
Administration Expenses	1,000.00
Selling Expenses	500.00
Total	$ 8,500.00
Accounts Payable at beginning	1,000.00
	$ 9,500.00
Accounts Payable at end	1,000.00
Monthly Disbursements	$ 8,500.00
Cash Surplus	$ 5,000.00

If the disbursements are in excess of the expected receipts, then a bank loan is required. Thus a forecast of cash receipts and disbursements must be prepared to provide for necessary capital. A forecast of operating results is advisable so as to obtain maximum production at minimum cost of time, expense and energy.

Planning for profits means giving the executive complete data on the progress and condition of his business within a short time after the close of the period. If possible,

weekly information should be submitted as to number of garments sold of each style, cost of such garments, and per cent of gross profit after deducting discounts. The good and bad selling numbers will then be known and the loss due to mark-downs determined. The mark-downs often cause drastic losses. A cushion should be provided in the calculations to take care of this shrinkage.

To plan for profits means also not to enlarge inventories without watching sales. Stocks in excess of amounts that could be used in expected sales must be worked down. Stock sales ratios are very important.

When preparing a balance sheet, one reserve besides the usual ones should be set up, and that is "Reserve for Contingencies and Inventory Losses." That is a very important item as such reserves will prevent the payment of dividends or disbursements of profits. No one ever knows the outcome of a coming season, so plenty of cushion should be provided for pitfalls.

A Budget for a Dress Concern—Its Preparation and Application

By Sol Federgreen, C.P.A.

The applicability of budgeting or intelligent business planning to the garment industry, particularly that part of it which has to do with the manufacture and distribution of ladies' dresses, has been demonstrated by the alert accountant by his lending practical assistance to business management through progressive thought born of cumulative experience with numerous similar enterprises. It is not enough merely to supply statements showing results of operations at the conclusion of an accounting period.

The business is seasonal and hazardous, and the client is wise indeed if he consults an accountant of proven capacity in the industry.

The budgetary principles enunciated in this paper apply equally to a new venture as to an already established business. Of course the budgetary figures will be governed by the amount of capital invested or to be invested, the type of dress business to be conducted and the price range that is adopted.

This paper will not deal with the actual figures of a budget because of the many types of dress businesses in operation. Suggestions as to bugetary procedures will be advanced and the discussion will be directed to the value that may be derived from the budget and the method by which it may be established and operated.

In order to awaken and hold the interest of a dress manufacturer there must be a realistic approach to the establishment of a budget. We are concerned not alone with the peculiarities of the business but we have to deal with practically-trained individuals who are inclined to rely only upon their own timely business judgment. It is not an easy matter to persuade such persons to chart and guide their business operations and progress through the use of predetermined statements or statistics, which to them are often incomprehensible. Usually, such men have small patience with figures and have an abiding faith in their own demonstrated abilities, but they have, however, come to understand that their bankers and important credit extenders look more favorably upon their business if they find that it is being conducted in accordance with a well-established plan.

No business man of vision today can fail to be impressed by the need for establishing preliminary estimates, and the accountant becomes more valuable to his client if he is

able to supply constructive suggestions based on experience. The budget represents the best estimates at the time it is made, but it should be subject to change as new conditions demand.

The accountant should advise and counsel the business man with respect to the adequacy of the capital with which his venture is to be launched. He should inquire into the particular type of dress business and price line which the client proposes to handle. The success of the business will depend to some extent upon the ability of the designer. the costs incurred in designing and making up models for display to prospective buyers are usually very substantial, and upon the reception accorded the models at such "showings" may hinge the continued existence of an enterprise.

The capital invested and the borrowing capacity of the business are very important matters because the dress industry reaches seasonal peaks when unusual demands are made upon the cash resources of the business. The slow months of the year also eat into the resources of the business because in those months the new lines are created.

In order to make for a successful organization the designing, production, selling and administrative departments must be coordinated, and cooperation is required all along the line. The worthwhileness of the budget is to be decided in the light of actual accomplishments, and adequate and efficient accounting is necessary in order that dependable estimates can be made. In budgeting we cannot be guided solely by past performances. Current conditions and changing circumstances must be taken into account and the budget must, therefore, be made flexible.

In the course of establishing a budget a manufacturer is sometimes made aware of the impracticability of some of his preconceived notions and the hopelessness of conducting profitable business operations in accordance therewith. He thus can be made to realize that he has been spared the necessity of making expensive, valueless experiments. He can be taught to refer continuously to the budget and to seek explanations of important deviations therefrom in the conduct of his business.

Because of the volatility of the dress business the budget should preferably cover two seasons, including good and bad months, as follows:

1. November 1st to May 31st.
2. June 1st to October 31st.

In the case of concerns whose seasons vary slightly from the regular run of the dress business, the above mentioned periods should be revised to give effect to the particular business under consideration.

Of course the capital of the business has a bearing on the sales volume, and due consideration must be given thereto. If the client had been in the same type of business before, the accountant can use as a guide the volume that had theretofore been obtained. He should, of course, discuss with his client the possibilities of attaining anticipated sales volumes. The figures arrived at should not be the product of guess-work, but should represent the considered judgment of the management as to the prospects of business to be obtained by its sales force on the basis of past performances of the individuals involved and a knowledge of the lines that will be created for display to prospective buyers. A sales forecast should be made for each month of the budgeted period for the reason that varying factors will have a bearing on the volume that may be expected in each such month. The actual and projected volumes should be compared monthly and any

marked variations reported to the management.

Inasmuch as the prospective sales performance is the basis upon which the other statistical factors are predicated, it is important that dependable sales estimates be made.

An accountant with experience in the garment industry acquires valuable knowledge of mark-ups and ratios of costs and expenses to projected sales volume. Altogether too often a client understands only what mark-up he would like to obtain, but his understanding of cost determination is too faulty to permit him to arrive at accurate computations of his probable cost without the guidance of his accountant. The client rarely gives proper consideration to the probable extent of returned sales and their re-sale at close-out prices. He also fails to consider his need for a proper initial mark-up so as to net him a sufficient return in the event that he cannot conclude regular sales in sufficient volume and is obliged to dispose of a fairly considerable quantity of merchandise at "job" prices.

The management's estimate of mark-up should be obtained and consideration given to the following extraordinary items:

a. Job sales.
b. Losses on sales of jobs.
c. Losses (or profits) on sales of raw materials.
d. Inventory mark-downs.
e. Other factors, such as post season adjustments with contractors and the write-off of contractors' advances.

However, the following items should appear in the cost calculations of each style:

a. Losses in cutting piece goods.
b. Remnants.
c. Allowances of yardages to contractors for large sizes and defects in materials.
d. Advance of 10% for cuts.
e. Sponging and dyeing.
f. Payroll tax on contractors' labor or own factory labor (about 1% of sales.)
g. Other known factors chargeable to the cost of sales.

After a satisfactory mark-up (before extraordinary expenses) has been arrived at, it should be reduced to provide for probable losses through job sales, inventory markdowns and the other factors mentioned above. Typical mark-ups for various price fields follow:

Selling Price	Rate of Mark-up
$ 2.25	10% to 15%
3.75	15% to 18%
4.75	18% to 22%
6.75	20% to 25%
10.75	25% to 30%
12.75, 14.75, 16.75, 18.75	28% to 33%
22.75, 26.75, 29.75, 39.75, 49.75	30% to 35%
49.75 and up	35% to 45%

With respect to businesses already established, the budgetary task is simplified somewhat because of the available record of past performances.

Sales discounts at 8%, the prevailing rate in the dress industry, should be deducted from the mark-up in obtaining the prime gross profit.

It is important to know how much the particular dress business can afford to pay as salaries for the designing department. Houses manufacturing garments to sell from $2.25 to $6.75 do not, as a rule, employ designers. Their lines generally represent the result of "breaking down" styles in the upper price classifications. A number of houses in the $8.75 and $10.75 ranges also do not employ designers. Establish-

ments selling garments for more than $10.75 employ from one to three head designers, whose salaries run between $100 and $500 per week, together with the following complement for each designing room:

a. Assistant designer (salary between $45 and $65 per week.)

b. Four to six operators (salary about $35 per week for each operator.)

c. One finisher (salary about $22 per week.)

In addition, a sketcher is usually employed for all designing rooms.

It usually takes between six and eight weeks to complete a line, and there are lapses of from two to three weeks between seasons during which sample hands are not employed. The auditor should, therefore, work in collaboration with the client to chart the weeks during which the designing rooms are to function and help him decide upon the number of persons to be employed therein, on the basis of which the monthly expenses can be figured.

Houses manufacturing dresses that sell between $2 and $10 as a rule recover the cost of materials used in the designing department upon the sale of the samples produced therefrom. In the case of dresses selling from $12.75 to $22.75 the unrecovered cost would run between 15% and 20%, i. e., from 80% to 85% of the cost of materials would be recovered. With respect to dresses selling for $22.75 and upward, the unrecovered cost of materials would range between 20% and 25%.

Provision should be made for loss on sale of samples in the designing overhead. In the case of a new business this will be especially difficult because the prodigality of the designer in the use of fabrics cannot be measured.

A designer makes two or three trips to Europe each year at a cost of between $1,200 and $1,500 for each trip, exclusive of the cost of models purchased. Designers are obliged to purchase from four to eight models at a cost of about $250 each for the privilege of inspecting the latest designs. After these samples are brought to the United States under bond and have been used by the designer for copying and for the development of ideas, the models are returned to Europe and a comparatively small recovery of their cost is made.

There are in this country establishments that are devoted to the development of designs, and they derive their income from the sale of sketches. Most of the higher priced dress houses subscribe to this service.

All expenses in connection with designing a line may be shown in the months in which the expenses were incurred, or they may be prorated equally or on a sales basis over the period benefited thereby. The more conservative method is to charge them off immediately.

If a client operates his own factory, either alone or in conjunction with contractors, the accountant should devise records that will show the client whether his factory is being operated efficiently. In order to do this the factory should be handled as though it were run by a contractor. It should be charged with all materials sent to it, the labor involved and an allocable proportion of the overhead. The factory should be credited with dresses delivered by it.

Advertising may sometimes entail a cost out of all proportion to the volume of business that the client may reasonably expect to obtain. This item of selling expense should, therefore, receive special consideration so that retrospective self approach will not be necessary if

this expense is found to be far too burdensome.

The number of employees and the salaries that may reasonably be paid in each department, predicated upon the anticipated business volume, must be carefully studied and charted so that the company will operate under a reasonable overhead load.

Each department head should be fully apprised of his responsibility as outlined in the budget and he should be encouraged to make frequent reports to show whether or not he is conducting his department within the prescribed expense limits. It is vital to keep expenses under control before it is too late and a complete reorganization of a business becomes urgently necessary.

Comparative monthly statistics of actual performance and budgetary expectations should be compiled, as well as cumulative comparative statistics between this year and last year.

Executive salaries must be in keeping with the business performance, and the client must be advised against drawing salaries that are not warranted by the volume of business he has been able to attain.

With respect to such expenses as rent, amortization of leasehold, improvements, and depreciation of machinery and fixtures, the accountant refers to the terms of the lease and to the actual or proposed investment in fixed assets. Sundry general and administrative items as telephone and telegraph, stationery and printing, postage, legal and auditing, insurance, credit services, etc. are usually established on the basis of the experience of other businesses most nearly approaching in complexion the one under consideration. Social security taxes are predicated on the estimated salaries to be paid to the employees.

Provision should be made in the budget for losses from bad debts, which usually runs from ½% to 1% of the net sales, interest charges and other deductions from income that can be estimated with any degree of precision.

After tabulating all the expenses and other deductions from income, the accountant is in a position to inform the client whether the operations for each of the months covered by the budget are expected to yield a net profit or loss.

The budget should chart a conservative course of operations and should be based on minimum expectations. By comparing the actual results with the anticipated figures at regular intervals, the accountant can appraise the efforts of the management and arrange for revisions of policy in order to achieve the desired results. Such a study may indicate the need for an intensified sales campaign, an improved markup or a curtailment of expenses, and timely action may in this way be urged upon the management.

Men's Clothing Industry

By A. Albert Greenspan, C.P.A.

The men's manufacturing clothing industry, embracing approximately 4,000 manufacturing establishments throughout the United States, employs more than 175,000 workers and does an annual volume in excess of one billion dollars. Approximately 40% of this business is done in New York City.

A comparison of the men's clothing with other apparel industries reveals the following outstanding contrasts:

1. The industry's need for substantially larger working capital.

2. The requirement of large manufacturing plants.

3. The complexity of manufacturing processes.

4. The adaptability to the industry of precise accounting for units manufactured and sold, and the maintenance of accurate cost records.

Clothing manufacturers may be classified in major groups as follows:

1. The manufacturer who purchases piece goods, trimmings and supplies; owns or leases the manufacturing plant, and cuts and manufactures men's outerwear. In order to spread overhead over a greater number of units he may often engage in contract, or "cut, make and trim" manufacturing.

2. The manufacturing jobber, in all respects similar to the above, but whose manufacturing operations are limited to cutting of piece goods and trimmings which are sent out to contractors who "make" the clothing.

3. The jobber, whose business parallels that of the manufacturer except that he buys piece goods (and not trimmings or supplies) which are forwarded to a "cut, make and trim" contractor for manufacture, according to specifications.

4. The "cut, make and trim" contractor, whose functions are purely manufacturing.

5. Retail manufacturing chain stores which purchase materials, manufacture garments and sell them in their own stores direct to the consumer. In recent years manufacturing retail chains have made very substantial inroads into the volume of business handled by other classifications of manufacturers in the industry.

Products sold in the men's clothing industry are graded, the lowest number denoting the cheapest form of manufacture. The following is a summary of the various grades and approximate retail price ranges:

Grade	Standard Retail Sales Price
1	\$15.00 to \$18.00
2	18.00 to 22.50
3	22.50 to 25.00
4	25.00 to 30.00
5	30.00 to 35.00
6	35.00 to 50.00
Special	50.00 and over

Most manufacturers limit their production to three or less grades, in order to obtain rapid and efficient production and to establish good will in their ability to produce superior garments in the grades handled.

I will limit my remarks to the manufacturer who makes garments in Grades No. 2, No. 3 and No. 4, who is fairly representative of the industry.

The peculiar nature of the men's clothing industry involves the need for a working capital substantially larger than in other apparel lines. Some factors in this need are:

a. The necessity of extended pre-seasonal preparation. Usually, three to four months before production starts, sample swatches of the many cloths must be purchased, the sample line created and duplicates made. Purchase commitments usually are made for a predetermined quota of the coming season's woolen requirements. After salesmen are out on the road for approximately six weeks, their orders received are analyzed into various styles, cutting orders are issued and the factory starts manufacturing.

In the meantime, deliveries of woolens by the mills are being received daily. Upon receipt, the goods are sent out to spongers where they undergo a shrinking process. Defective merchandise is returned to the mill. Shrinkage is an important item in the cost calculation, for it ranges from three to as high as eight or nine per cent of the original yardage. In cases where it results in a

substantial loss in width, the mill will grant an allowance.

This pre-seasonal preparation results in a very heavy drain of working capital. Manufacturing, selling and basic overhead expenses continue at a time when sales are negligible.

b. Since the cycle of factory production averages from three to five weeks, labor payrolls, in addition to ordinary expenses, must be financed.

c. The average period of credit extensions on sales. Goods are sold to retail customers generally on a 30- to 60-day basis, but analysis of the receivables of any representative manufacturer discloses that the period from date of shipment to date of collection will average 75 days.

Terms of purchase for materials usually run 60 days, with an additional 60 days at 1% interest.

During the season the factory works at capacity and payrolls and overhead reach their maximum. It is necessary that adequate working capital or proper merchandise and bank credit be available to finance these expenses for approximately 4 months.

d. Inventory of finished merchandise and inventory carry-over. A substantial stock of finished goods must be carried in order that immediate delivery business may be done. Merchandise carry-over is increased by sizes and assortments. Garments of a given style are made up in sets of six or seven sizes, ranging from 33 to 50, with a certain proportion of Regulars, Longs, Shorts, Stouts, etc. During the season these sets very often are broken up by shipments. At the close of the season the manufacturer probably will find himself holding an assortment of miscellaneous sizes and shapes which either may be sold at a loss or filled-in in the following year's production. Most houses carry staple merchandise such as Serges, Oxfords and Bankers, which is sold in both seasons of the year, as opposed to the fancy line which is usually seasonal. With all these factors present, a carry-over of merchandise with its accompanying strain on liquidity is almost certain.

The foregoing emphasizes the great need for ample working capital in the industry and accentuates the requirement of careful advance budgeting of operations.

I have prepared a specimen budget for a men's clothing manufacturer making garments in Grades No. 2 to No. 4, starting business during October with capital of $100,000.00, of which $40,000.00 is expended in a full plant, consisting of coat, vest and pants shops. He contemplates an annual volume of $600,000.00, of which $300,000.00 will be shipped during the first season. A manufacturer should plan to have a turnover of no more than eight times the working capital, with annual expenses equal to working capital.

Based upon the following budget he has made arrangements with his banks for credit of approximately $50,000.00. It is estimated that shipments will be made as follows:

December	$ 15,000.00
January	35,000.00
February	75,000.00
March	115,000.00
April	50,000.00
May	10,000.00
Total	$300,000.00

Production is budgeted for the season at a sales value of $315,000.00 which will provide for an inventory carry-over in staples of approximately $15,000.00. Expenses and bad debts are estimated to be 10% sales, and net profit 5%. The remaining 85% covers prime cost, 54% of which represents the cost of woolens, trimmings and supplies; 40% labor and 6% manufacturing overhead.

The production cycle is estimated

to be 4 weeks; receivable collection period 75 days; merchandise maturities 120 days, and expenses have been allocated in proportion to activity.

Element of Cost or Expense	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Labor	$ 2,500	$ 8,500	$18,500	$34,000	$29,500	$13,500
Manufacturing Overhead	1,500	1,500	3,000	4,000	4,000	2,000
Expenses	3,000	3,000	6,000	7,000	8,000	3,000
Merchandise, Maturities	....	....	....	....	3,500	11,500
Total Outlay	$ 7,000	$13,000	$27,500	$45,000	$45,000	$30,000
Collections on a/c rec.	....	....	....	7,500	25,000	55,000
Excess or Deficit	$ 7,000D	$13,000D	$27,500D	$37,500D	$20,000D	$25,000E
Opening Cash Balance	60,000	53,000	40,000	12,500	5,000	5,000
Total	$53,000	$40,000	$12,500	$25,000	$15,000	$30,000
Bank Accommodations	....	....	....	30,000	20,000	....
New Balance	$53,000	$40,000	$12,500	$ 5,000	$ 5,000	$30,000

D Deficit. E Excess.

For the months of November, December, January and February total outlay for labor is $63,500.00 for manufacturing overhead $10,000.00, and for expenses $19,000.00—a total of $92,500.00.

Collections on accounts receivable, according to the credit period estimated to be 75 days, will begin during February, and will amount to only $7,500.00, resulting in an excess of cash outlay over income for the four months of $85,000.00.

Since the original cash investment, after the payment for fixtures, is $60,000.00, there will be a cash deficiency during the month of February of $25,000.00. Borrowing to the extent of $30,000.00 therefore, will be required in February.

In March, the total outlay for labor, overhead, expenses and for maturing merchandise bills, will be $45,000.00. Receivables are estimated to bring in $25,000.00, with a resulting deficiency of $20,000.00, which will have to be borrowed.

In April, estimated collections on receivables will be sufficient to offset outlay for all costs and expenses, and during May loans could be reduced or merchandise invoices anticipated.

Actual operations very seldom exactly parallel forecasts. Such elements as factory labor troubles, with possible cancellation for late deliveries; failure of the mills to deliver on schedule; unexpected increases and decreases in sales orders, and other contingencies tend to vary results as compared with the budget. Revision of advance estimates must be made from month to month to conform to existing conditions.

It is my conclusion that the company operating under a budget along planned lines has a greater probability of success.

The second major outstanding difference between this and other apparel industries is its need of large manufacturing plants with varied machinery and equipment. In an up-to-date men's clothing plant are dozens of improved types of sewing machines. Typical are buttonhole machines which cut the cloth, sew and tack the buttonhole in a fraction of a minute; machines to sew buttons; revolving disk cutting machines; vertical blade cutting machines; felling, basting and ticket sewing machines and a wide variety of mechanisms to press the many different parts of the garments. All this is needed for efficient operation and represents a very substantial investment.

It is esential that a plant ledger be maintained which will reflect, for each machine, its description; date of acquisition; cost; serial number; estimated life; cost of repairs; annual depreciation and ultimate disposition. This record can be an invaluable aid to the management in disclosing the effectiveness of machinery, and as a means of comparison between makes. For income tax purposes, it substantiates the deduction for depreciation and furnishes the cost on disposal.

The third major problem is the complexity of manufacturing processes. In making pockets alone there are 13 different operations. One style of a garment may be made in 13 sizes, ranging from 33 to 50, in sport or plain models, with variations in lapel and pockets and in assortments in fit. Scientific investigations of the average proportions of the human body indicate that 45% should be manufactured as regular, and the balance long, short, stout and other variations.

These difficulties in manufacture add problems to the accountant's work. For example, in installing a payroll system, strip tickets must be provided for piece work operations. As the garment moves along to completion the employee performing the individual operation tears off his strip as evidence of having performed the work called for. At the end of a pay period these tickets are turned in to the payroll department to be counted and computed.

The factory should be departmentalized so that it is possible to ascertain from records the cost of each group of major operations on a garment, such as designing, cutting, trimming, coat, pants and vest operating, finishing, pressing and examining. These costs when accumulated should agree with the related general ledger totals. Some very interesting information can be furnished to the management from these sources and it is enabled to make comparisons from season to season.

The most important subsidiary record maintained in a well established men's clothing manufacturing firm is the manufacturing book, which I will describe briefly.

It is a unique form, tracing the piece goods from the time of original order given to the mill to the time of the ultimate disposition of the garment made out of that specific piece of goods. The key number on the form is the lot number according to which the book is numerically arranged. The sheets are loose-leaf and provide for the following information:

The name of the mill from which the goods is purchased; mill style number; price; terms of purchase; and lot numbers appear on the head of the sheet. The date; quantity; delivery date and acknowledgment of the purchase order appear in one section of the form, and space is provided below for recording cancellation of purchase orders. Another section records date of receipt of the goods; piece number; yardage and width. While on the topic of incoming piece goods, it is well to advise your men's clothing clients that when they order piece goods from a mill they should specify not only the number of pieces desired, but also the approximate total yardage to be contained in these pieces. When the market is rising or falling rapidly, some "chiseling" mills take advantage of customers who order only by total number of pieces by reducing or increasing the yardage in the pieces in accordance with the mill's interests.

The third section of this form indicates the consumption of goods, containing the cutting ticket number, yards used and balance on hand.

The fourth section contains an analysis of the sizes into which the

particular lot has been cut, a description of the model and total quantity cut.

Orders received from customers are recorded, on the lower part of the form as follows: Name; date; customer's order number; delivery; price; model; quantity ordered; description; cut number and the various sizes ordered. As goods are shipped the quantity in the size column is encircled. Space is also provided for the total number of garments contained in each shipment and the quantity returned by the customer.

My office recently had occasion to check out a season's operations into a manufacturing book. The result was really amazing. There were just three garments unaccounted for in comparison with the physical inventory, and the piece goods records showed only small fractional shortages. The company incidentally, did a volume for that season of close to $400,000.00.

A record such as this, carefully maintained by a trustworthy employee, provides an adequate safeguard against pilfering, particularly if the accountant makes periodic test checks.

Another subsidiary record of importance is a combination cutting and statement ticket, containing perforated statement strips which are sent to the coat, vest and pants shops with each lot of cut merchandise. Instructions to the foremen of the respective shops are contained thereon, indicating any special procedure to be followed in the manufacture of the lot.

Other forms of interest are the sales order form which contains detailed information on each customer's order; duplicate stock sheet records which are sent to branch offices and special order tickets containing complete details for the manufacture of the many special orders received by men's clothing manufacturers.

The general ledger accounts recording assets, liabilities, reserves and capital are similar to those of any other manufacturing business and need not be enumerated. However, the cost accounts contain certain elements peculiar to the industry, and I am therefore enumerating them: Purchases of woolens; thread; tickets, tags and labels; swatches; weaving; sponging; express and hauling in; Federal Social Security; State Unemployment Insurance Taxes, direct labor—coat, pants and vest shops, cutting and trimming; and designers' salaries.

Grant Thornton
S E C

Reprinted from the May, 1939 Issue of "The Journal of Accountancy of the American Institute of Accountants"

Testimony of Expert Witnesses at S.E.C. Hearings

IN the last issue of THE JOURNAL there was presented a summary of the testimony of the first five expert witnesses examined at the public hearings called by the Securities and Exchange Commission in its investigation of accounting questions arising from the McKesson & Robbins case. It was announced that additional material drawn from the testimony would be presented in this issue. For a general introductory statement regarding the scope of the hearings and the plan of these articles, readers are referred to page 199 of the April issue.

Each of the expert witnesses was asked 129 prepared questions, most of which gave rise to other related questions. Examination of each witness occupied a full day of the hearings and fills approximately 120 pages of the record. It follows that any summary presented at this time can be only indicative of the type of question asked and the nature of the testimony given on subjects of general interest. No attempt is made to treat all subjects, nor to present all the testimony on any one subject.

The first article dealt with the testimony of the following witnesses: Samuel J. Broad, C. Oliver Wellington, Victor H. Stempf, William H. Bell, and Norman J. Lenhart, all of New York. A general statement on the nature of auditing which Mr. Broad read at the beginning of his testimony was reproduced, and the testimony on several subjects concerning which there was substantial agreement was presented. Under a separate heading, the testimony dealing with accountants' responsibility for inventories was described at some length.

This second article treats some of the same subjects, drawing from the testimony of the last seven witnesses, who were, in the order of their appearance, as follows:

John K. Mathieson, of Philadelphia
Henry A. Horne, of New York
Charles B. Couchman, of New York
Hiram T. Scovill, of Urbana, Ill.
Joseph J. Klein, of New York
George D. Bailey, of Detroit
Charles W. Jones, of Chicago

Again, because of its length and relative importance, the subject of accountants' responsibility for inventories is treated under a separate heading.

The interrogation of the witnesses was conducted by William W. Werntz, chief accountant of the S.E.C., with Adrian C. Humphreys presiding as examiner.

The Nature of Auditing

At the close of his examination, Mr. Couchman was asked by Mr. Wernst whether he had anything to add to the testimony which he had given in response to particular questions. His reply, which was in large part a discussion of the need for general understanding of the scope and limitations of audits, is here quoted in full:

"A. I would like first to emphasize one element that has some bearing upon the scope of the public accountant's examination, and that is the time limitation set by those over whom the accounting profession has no control.

"The major portion of the great majority of examinations must be performed between the period of the closing of the books of the commercial organizations and the date when reports should be sent to directors

or stockholders before stockholders' meetings. These two dates are beyond the control of the accounting profession.

"Usually they are set for a particular corporation by its charter and by-laws, frequently at the suggestion of the company's attorneys.

"This pressure is further accentuated by the time limitation set by various practising authorities and by other governmental bodies such as the S.E.C. requiring reports to be rendered within a specified period after the closing of such fiscal year.

"In fairness to the accounting profession, it must be recognized that to a large extent and wholly aside from other factors, the scope of its work is limited from the time standpoint by authorities wholly outside the control of the profession. The fact that the great majority of corporations have set December 31st as the close of their fiscal year puts a tremendous burden of time pressure on the public accountant.

"I suggest that there are two steps which might be taken by corporations which would relieve this pressure to some extent.

"One is that the public accountants be notified of their election as early as possible in the year and be allowed access to the records at any time during the year. This would enable some portion of the work to be performed before the close of the fiscal year.

"The second is the adoption by corporations of a fiscal year which is natural to each individual business, that is, a fiscal year which will close at that month-end which has been shown by experience over the years to be the one at which there is the lowest ebb of activity.

"I suggest that the Securities and Exchange Commission may be of great assistance to public accountants in aiding in the adoption of these two recommendations.

"Going back to your question, 'Have you anything further to say?': The difficulty presented to an accountant to answer this question properly is somewhat like that faced by an attorney, of whom one has asked 128 questions regarding the practice of the law, and then ask: 'Have you any questions or suggestions to offer regarding legal questions which have not been developed?'

"Regarding the questions which have been asked in this hearing, it occurs to me that there is a danger that the questionnaire may be considered by the public as a broad cross-section of what public accounting work is and as implying that the practice of accountancy is little more than the following of a more or less rigid code of auditing steps.

"Much of the accountant's work covers many other phases that have not been emphasized by this questionnaire, but which may have a greater effect on stockholders' interests than do the matters which have been stressed.

"Among these are such matters as questions of general conservatism or otherwise of the company's treatment of items affecting its balance-sheet and its operating statements, proper treatment of transactions creating surplus of various types and the propriety of charges made against each, problems of reorganization and of refinancing, with proper presentation of the resulting effect.

"This is all supplementary information to be set forth as footnotes or otherwise in the financial statement.

"Analyses of all types of contractual obligations and of governing laws to determine and measure the effect upon various elements in the balance-sheets and in the income statement; analyzing availability of surplus for a variety of usage under the terms of various laws and of in-

dentures; problems concerned with the preservation of and impairment of a corpus of a legal entity; the reasonableness of a variety of items which are not within the scope of definite accounting determination; the consolidation of accounts and treatment of intercompany items of corporations and subsidiaries—these are only a few of the multitude of problems forming the duty, from day to day, of the public accountant, but scarcely touched upon at this hearing. Such matters as these are an integral and an important part of the accountant's examination.

"Throughout the commercial world, these matters and their effects are of infinitely more importance to stockholders and to creditors and to the continued existence of the corporation than are the irregularities that occasionally may be found in inventories and in customeres' accounts.

"The questions today have centered on a pamphlet of some forty pages. There are thousands of pages of text concerning accounting and auditing with the subject matter of which the public accountant must be familiar in the practice of his profession.

"It must be kept in mind that accountancy is not an exact science and therefore the detailed method employed in its practice cannot be exactly tabulated.

"In the type of examination performed in connection with the rendering of a report upon financial statements to be issued to stockholders or for credit purposes, the primary service is to establish a reasonable ground for the belief, or opinion, that is set forth in the accountant's report. Sound opinion cannot always be determined by set formula.

"Since a primary purpose of the examination is to enable the accountant to satisfy himself as to the general truthfulness of the financial records, it is evident that the process is subject to the same variations as to methods that apply in any attempt to determine truthfulness of individuals or of alleged facts or other circumstances, such as the attempt of the law to determine truth in legal cases. The procedure must vary as the circumstances warrant.

"As to the general scope of the usual examination, the public accounting profession has had to be practical and to attempt to determine the greatest common denominator of need.

"At one extreme, there may be such a thing as an audit so incomplete as to be of little value to the commercial world; at the other extreme, the complete detailed audit which would be so expensive that very few corporations could undertake it except under most unusual conditions. Generally speaking, its cost would be prohibitive.

"Between these two extremes, the profession has for many years endeavored to determine that scope of examination which, broadly speaking, will be of the greatest value to the business community in proportion to its cost. The trends of thought or of our demand from time to time may vary the scope. It may prove insufficient in a particular instance, but consideration must be given as to how well it meets the needs in all other instances.

"In all cases of test check there is the possibility that an error may lie in some untested section. That is true, however, in all activities of business or professional work or human relationship or politics or of life itself, in cases where complete and perfect knowledge of a matter is unattainable.

"In all preventive lines of endeavor, whether directed against fraud or disease or accidents or crime or property loss or loss of faith, perfect prevention is an idealistic goal rather than a practical accomplishment.

"The accountant in his work can only do his best and exercise his best judgment based upon his experience, his knowledge of the experience of others, his ability, natural or acquired, any sixth sense he may have developed for smelling out irregularity, and the following of such procedures as have proven effective.

"Accountants are human. We do not seriously mind increased business, but we are interested in knowing whether an increased value will result to the people we serve. We want to render as valuable a service as possible, and I think we will continue to strive to improve and will welcome any intelligent aid toward that end."

Accountants' Responsibility for Inventories

For purposes of this article, the questions dealing with accountants' responsibility for inventories which were asked the expert witnesses at the S.E.C. hearings have been grouped under general subject headings. The testimony given on each of these subjects by the first five witnesses was summarized or quoted at some length in the April issue. The testimony of the last seven witnesses has now been examined and is summarized on the following pages, which should be read with reference to explanatory matter on page 279 of this issue, and a more detailed introduction beginning on page 199 of the April JOURNAL.

Pricing

Each witness was asked the following question: In your opinion, is an accountant responsible for the pricing of inventories in accordance with generally accepted accounting principles? Mr. Jones, in general agreement with the other witnesses, replied as follows:

"A. In my opinion, it is the responsibility of an accountant to satisfy himself that the pricing of inventories is in accordance with generally accepted accounting principles."

His examination continued:

"Q. The basis of pricing inventories involves the question of market price. What market price is meant, for example, in the usual phrase 'cost or market, whichever is lower'?

"A. Market ordinarily means the lower of replacement cost or selling price less allowance for selling.

"Q. Are those alternatives or both applicable in any given case? That is, do you use one or the other?

"A. We use the lower of the two.

"Q. The lower of the two markets in an individual case?

"A. Yes.

"Q. How do you determine what market price is applicable? Take the replacement market.

"A. Well, in the case of a manufactured product, it is the current cost of producing it. In the case of a purchased article, it is the current cost of buying it.

"Q. In the client's market—buying market?

"A. Yes.

"Q. Do you have to determine whether the quantities are consistent with the client's requirements?

"A. Yes, we do."

On the methods of computing cost, Mr. Bailey testified as follows:

"There are about as many different methods in computing costs as there are in [computing] market. I had an occasion of addressing a group of accountants in Indianapolis on inventories, in the discussion which followed, I asked each man who stood up to express the basis on which his company took inven-

tory and they were all different. Most of them said that they were following cost-or-market basis.

"I have a feeling that we, as accountants, must challenge our general acceptance of the idea that it didn't make much difference what inventory basis was followed as long as it was consistently followed.

"I think we can find that there are preferred methods of pricing inventory at cost for respective inventories, methods that will come more nearly to reflecting the true income as against pure bookkeeping income which follows from some of the methods now in vogue. I think that is one of the problems that accountants have before them right now.

"Q. That would perhaps be by industries or types of business?

"A. My thinking isn't crystallized to its final conclusion, but I think that what we should look forward to is an improved method for individual industries.

"Q. Now, in view of your comment as to possible ambiguity of the term 'cost,' do you think it might be desirable to go a little bit further in describing what is meant by cost?

"A. Well, I think you have a problem as to whether or not you are disclosing information that one would know what to do with in the report. As to the condensed stockholders' reports, I am not quite as clear on that point as I am on more detailed reports. I do think that we should move forward to more clearly defining what particular method of cost or market is being followed.

"Q. Would it possibly be that you could group these methods under relatively widely spread categories and then describe the category?

"A. Well, that might be one way, although I am frank to say that I haven't quite seen the answer in my own thinking; merely to say first in-first out, last in-first out, base stock, does not necessarily answer the problem."

Mr. Horne's testimony on definitions of cost and of market and on the various methods of stating the value of inventory was substantially in agreement with the testimony of earlier witnesses. On the question of whether the method used should be described in the financial statements, his reply was more extensive than the others. Examination of Mr. Horne on this point was as follows:

"Q. Do you feel that the term cost or market is sufficiently explanatory or should there be a further indication of what is meant by cost and what is meant by market?

"A. Of course, I cannot go back on our reports that the inventory committee made, in the case of the oil companies, that when they adopted the last in-first out, they should say so on the balance-sheet. I think that that is so, but if one were to say that all of the possible variances of cost or market should be all spelled out in a classification and that cost, meaning form No. 3, and market, meaning form No. 4, should be used, I just don't think it would help the investors any. I doubt if it would help the directors. I think you can get to the point where you get such a multiplicity of financial detail that the reader is rather stunned and gets no clear comprehensible picture from the statement.

"Q. Is it possible for a given company to use two, or many, bases of cost with regard to its inventory, that is, different products being costed on a different basis?

"A. I think it is possible.

"Q. In which case, to go further, you would have to indicate the proportions?

"A. Yes, with respect to each cost. That is possible. While nothing comes to my mind at the moment, I would not say that I have not seen that arrangement. The Treasury Department does not look

upon it with favor, but practically I think it is done."

Goods on Consignment

Each witness was asked what procedure he considered necessary in determining that goods held or shipped by the company on consignment were properly treated in the inventory.

Mr. Horne said that he would obtain from consignees confirmations of the quantities of goods shipped on consignment, and also would obtain from consignors confirmation in the case of goods held by the client. He testified that in the case of consignees who, according to the records, held no goods but with whom there had been regular consignment business in the past, he would obtain confirmation of the fact that no goods had been shipped, unless there was a sufficient evidence in explanation of the facts from other sources.

Mr. Mathieson testified that it was his practice to obtain confirmations from consignees and consignors. Consignors were asked to confirm, he said, if there had been any such transactions within six months of the balance-sheet date.

Mr. Couchman testified that his procedure would depend somewhat upon the character and size of the company. Ordinarily, "the records maintained and the internal check and control should establish quite definitely . . . the validity of the accounts as being consigned in or consigned out," he said. If the transactions were significant in the sense that they were unusual and involved large amounts, he would obtain confirmations, he added.

Examination of Mr. Scovill was as follows:

"Q. Would you expect him to make confirmations with the consignors and consignees . . . ?

"A. From ordinary correspondence, one might get enough information, but I think it would be most desirable for one to try to get independent confirmation with regard to consignments in the hands of consignees just about as one might get confirmation from a trust company with respect to certain securities, et cetera, without any special arrangement.

"Q. Under such circumstances, would you think it desirable to send confirmations to any person with whom the company had been in the habit of dealing on this basis, irrespective of whether the record shows that the goods were held on consignment or not?

"A. I think that would be a very good safeguard, yes. That is often, I think, overlooked by accountants not only in connection with merchandise but in some other things."

Dr. Klein stated that, if confirmation of goods held or shipped as consignment were considered desirable in the circumstances, confirmations would be sought even though there were no open accounts at the close of the year. Whether there should be confirmation in the absence of recorded transactions, according to Mr. Bailey, would depend upon whether there were grounds for suspicion that there had been transactions which were unrecorded.

Mr. Jones' testimony was as follows:

"A. We inquire as to the procedure followed in the inventory with respect to goods held on consignment. We check the records of consigned goods with the inventory to ascertain whether or not such goods have been excluded.

"Goods shipped on consignment are checked against the consignment records and we normally correspond with the consignee or consignor with respect to any stocks of major size to ascertain the correctness of the records.

"Q. If you found that a particular company had been engaged in

the course of business with a client on consignment, would you send out a confirmation even though the record showed no balance at the present time?

"A. Yes, I think we would."

Qualifications

The following question was asked of each witness: Having completed to your own satisfaction the procedure for examination of inventories outlined by the bulletin, *Examination of Financial Statements,* do you include in your report a qualification as to your responsibility for the quantity, quality, or condition of inventories?

Mr. Mathieson replied that, if he had completed only the procedure outlined in the bulletin, he would qualify his certificate as to quantity, quality, and condition. Should he supervise the inventory taking or make sufficient spot checks, however, the qualification as to quantity would be omitted, he said.

Mr. Horne testified:

"It has been our practice always to do enough work on inventory so that we do not feel any need of making any exception in our report.

"Now, that does not at all mean that we are willing to guarantee or to warrant that all of the goods are there, but it means that we feel a responsibility for expressing an opinion on the financial condition of the company, and this being the question that we are speaking of now, in which the inventory will be an important element or factor in the determination of the financial condition, we will always want to do enough examination of the goods themselves to satisfy ourselves that in general they have been in existence and that they have been in quantity and in value about what they are represented as being."

He was further examined as follows:

"Q. Now, if the procedure outlined in the bulletin as to inventories has been satisfactorily completed, I think you stated that it was not your practice to include in such cases any qualification as to your responsibilities for the quality, quantity, and condition. Is that correct?

"A. Yes, that's the fact. That's always been our practice. We have had perhaps something of an obsession about that. In my whole public accounting experience, myself and my partners, have never been willing to do that. That is, we have always felt that we were there to certify to the financial condition of the company and that we must find a way in which to give ourselves a satisfactory opinion as to whether the financial condition was as stated and we have kept on at the job until we could do that.

"Q. If you find included in the statements, or in the accountant's report, an indication that the auditor has relied upon responsible officials for information as to the quantity, quality, and condition of inventory, do you feel that this avoids the necessity of making the tests and inquiries that are outlined in the last sentence of item 3 under 'inventories'?

"A. Well. I can only answer from our experience. We have always felt we would do it in any event."

Mr. Couchman stated that, if the steps outlined in the bulletin had been taken, it was not his practice to include in his report a qualification as to quantity, quality, or condition of inventory.

Mr. Scovill saw no need for qualification under these circumstances.

Mr. Klein testified: "We do not qualify if the procedure which we have employed is sufficiently comprehensive to satisfy us that the representations as to value are substantially correct."

Mr. Bailey commented: "We haven't been making a practice of stating inventory certified by manage-

ment. For several years we have been getting away from it. We felt it was not sufficiently descriptive to have any particular weight as a qualification. As a general rule, we have not felt it necessary to comment on the absence of physical inspection of inventory where we were reasonably satisfied and, if we were not satisfied, an exception would have to be taken in definite terms. There has been a growing tendency in some of our offices to make a definite statement of the general extent of our inventory work, particularly in industrial companies where inventories are important."

Mr. Jones testified: "We do not include a qualification as to our responsibility for the quality, or condition of the inventories. Normally, the balance-sheet contains an explanation to the effect that quantities and condition have been determined by the company."

Checking Quantities

The last sentence of item 3 under the heading "Inventories," occurring on page 18 of the bulletin, *Examination of Financial Statements,* is as follows:

"Make reasonable tests and inquiries to ascertain that quantities have been carefully determined and that quality and condition have received due consideration."

Each witness was questioned as to what procedure he considered this sentence to require.

Mr. Mathieson said that in his opinion the tests intended by the Institute bulletin would include "verification of prices, of extensions and computations, footings, and probably at least a test check back to the inventory records themselves."

Mr. Horne's testimony in reply to this question was as follows:

"I think the preliminary sentences of that paragraph express the thing pretty well: 'The duties and responsibilities of the accountant in the case of quantities, quality, and condition of stock vary with the circumstances, but he must rely, principally, for information as to quantities, quality, and condition upon responsible officers and employees of the company. In the case of a business which does not call for technical knowledge and presents no substantial difficulties, the accountant, by special arrangements with his client, may be justified in assuming a greater degree of responsibility than in cases where expert knowledge is essential.'

"I think I would accord with that entirely. Then, 'Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition have received due consideration.'

"And, of course, the tests that I would think we should make as to quantities would be to see if there were some substantial items in the inventory that we certainly felt we ought to look into. We would make a verification by working back from the inventory, as of the particular day when our man would go out.

"He would say, 'Well, there are now—,' let's say, 'so many cases of those goods on hand. Do you agree with that?' 'Yes, there are so many cases here.'

"Then go back to the records and find that there have been records of sales of so many cases in the interval between that date and the inventory date and that there have been purchases of so many cases, and the arithmetic of that would indicate that there had been that many cases at the inventory date, approximately. Perhaps, since I am talking of cases, that ought to be 'precisely,' but that, of course, wouldn't apply with such extreme precision with respect to many other things. But I think tests of that sort are the things that I can honestly say we always make.

"Q. Would you make, also, tests of the records in case there were per-

petual inventory records, or tests of physical inventory records?

"A. Well, where there are perpetual inventory records, of course, the accountant's path is very much simplified. If there were perpetual inventory records, one might go out and look at what was there at the warehouse and come back to the perpetual inventory records. It should be the same. If not, why not?

"Q. Do you review the method which the client has followed in taking inventory?

"A. Yes, we always ask them quite definitely and clearly what are their instructions and we try to see that the inventory sheets and the general appearance of the inventory conforms with what they have said. If it doesn't, why, of course, we have to go and look further."

Mr. Couchman testified on this subject as follows:

"A. Well, to check the original inventory sheets with the office copy of inventory, to discuss the individual items with informed employees, to make sufficient test checks to satisfy yourself that quantities listed are reasonably correct. From this as a basis I think we can go on in particular circumstances as much farther as seems to be desirable.

"Q. When you say original inventory sheets, what have you in mind?

"A. The original sheets or count sheets are recorded by the individual who does the actual counting before they are assembled on the final.

"Q. If the system of inventory tags is used, do you refer to the inventory tags there?

"A. Yes, I don't mean that in the normal procedure we would inspect them all. I said tests of them. Not inspect them complete, but only test them.

"Q. Now, you referred to tests of quantities. What did you have in mind there? Actual count or inspection?

"A. If the organization has a continuous inventory system we might actually count certain items and compare it with the inventory count.

"Q. If it doesn't?

"A. If it doesn't, there isn't much we could do at the time we are in there to verify the quantity at some previous time, unless we wanted to follow the long procedure of counting some item and tracing all incoming and out-going items of that class.

"Q. Do you do that?

"A. Very seldom.

"Q. When you don't make that physical test, do you qualify your certificate?

"A. We do not.

"Q. If the accountant's report indicates that he has relied upon certificates from the management for information as to the quantity, quality, and condition of inventories, do you feel that this avoids the necessity of making any of the tests or inquiries which are indicated by this sentence we have referred to?

"A. No.

"Q. That is, those tests would have to be made anyway?

"A. Yes.

"Q. To clear up one other point. You said that you make certain tests as to quantities. Do you feel that that test is implied by this sentence if it is practicable?

"A. It may be implied by the sentence, but we feel that it is desirable although we do not feel that the accountant has any responsibility there by the very nature of his training, cannot be expected to have a full responsibility for the various types of knowledge that are necessary in order to determine a count or a computation or a measurement.

"Q. Would you say that the tests of quantities you make there are in the same sampling nature and with the same purpose in mind as the sampling of transactions, say, to see that this system of internal control, the records are accurate?

"A. Yes.

"Q. Without taking the responsibility for the entire quantity or the quality and condition of the inventory?

"A. Right.

"Q. Do you review the method followed by the client in taking these inventories?

"A. With new ones?

"Q. With old clients?

"A. We make an occasional review of the method. We usually know pretty well how they follow it."

"Reasonable inquiries and tests" were described by Mr. Klein as follows:

"A. Among the tests for the ascertainment of the correctness of quantity in inventory, I might mention the following, and let me say, parenthetically, the numbering is no attempt to indicate the relative importance, which depends on the circumstances:

"(1) That inventory procedure, including the control of tags and sheets, is sufficiently sound and is sufficiently well understood by the inventory squad and checkers.

"(2) That the inventory and checking squads have been adequate and that these squads understood their duties in the established procedures and that they observed such procedure.

"(3) Comparison of selected inventory tags, or other original inventory date with final inventory sheets.

"(4) Tests by comparison with quantities on hand (making due allowance for changes between inventory date and examination date) some of the relatively large items, that is, those that are large in quantity, as well as those which are relatively large in money value.

"These are some of the tests that come to mind, they might vary in extent as well as in kind, depending upon the circumstances. The inquiry involves discussion with the person or persons who signed the inventory certificate, as well as with some of the people who have actually taken the inventory, not limited to those in key positions.

"Of course, the verification of arithmetical accuracy and the fact that the client's squad check and recheck, where necessary, are included as steps that we would observe as to whether they had or had not been taken."

Mr. Scovill said that he did not believe that the words "reasonable inquiries and tests," as they were used in the Institute bulletin, were intended to include tests of physical quantities, but rather "a list of perpetual inventory records and inquiry directed to those who have taken the inventory or who have assisted in taking it."

In similar vein, Mr. Bailey testified:

"A. I don't think that sentence contemplates tests of physical quantities. I think it means tests of the records, because that is the only philosophy that is tenable with what has gone before with respect to that particular section.

"Limiting it to tests of the records has to do with examination of the procedure and investigation into underlying records such as cards and tags and original inventory sheets, discussions with those actually charged with the inventory taking, evidence that quality and condition is being reported by those who actually took the inventory, determination of procedure used in determining the cut-off, and a broad use of the various inventory controls which most companies have, including perpetual inventory records, if any.

"Q. Now, if the accountant's report or statements indicate that the auditor has relied upon responsible

officials for quantity, quality, and condition, do you feel that this avoids the necessity of making any of the tests which are contemplated by this sentence?

"A. No, I think those tests have to be made under any circumstances.

"Q. Subject, of course, to an express qualification.

"A. Of course, subject to express qualification in terms which can leave no doubt as to what is meant."

Mr. Jones offered the following explanation of the meaning of the words "reasonable inquiries and tests":

"It is hard to give anything but a general reply to that question because so much depends upon the individual circumstances.

"These tests and inquiries include a thorough investigation of the methods employed in determining inventory quantities. They include a review of the instructions which have been released to the company employees. The results are compared with perpetual inventories or other record controls that the company maintains; material differences are investigated and inspection of a portion of the inventories is usually made and in many cases test checks of quantities by count are made.

"There are numerous other broad tests that we may be able to make in particular circumstances.

"We pay particular attention to treatment of prior season or other old merchandise, and ascertain where practicable the rate of movement or use of such merchandise or material.

"In that way, we try to satisfy ourselves that recognition has been given in a proper way to age and condition in pricing them."

Methods of Taking Physical Inventory

In describing the important points in a satisfactory method of taking inventory, Mr. Mathieson was in substantial agreement with the earlier witnesses. He mentioned particularly proper planning in advance, a count by one crew and a re-count by another, and use of serially numbered cards or sheets.

In determining that satisfactory methods had actually been followed, he said, he would interview representatives of the management responsible for control of material, would discuss the procedures followed with the superintendents of departments where the larger quantities were kept, and would visit the plant to see that quantities on hand and the flow of the goods were as might be expected from production and sales. The auditor's procedure, however, would vary according to existing circumstances, he said. If he felt that unsatisfactory methods had been used and distortion of inventory values had resulted, Mr. Mathieson said, the auditor might request another taking of inventory or a suitable adjustment; he might also refuse to give a report.

After describing what he considered a satisfactory method of taking inventory and telling what steps he would take to ascertain that a satisfactory method had actually been followed, Mr. Horne was asked whether he would take any particular position if a client's methods were found to be unsatisfactory. He replied: "Well, we would, of course. There wouldn't be any question about that," and the examination continued as follows:

"Q. What would you do?

"A. It might require an entire new inventory. We might just decline to issue any statements at that time. If the plant had to be shut down and a whole new inventory taken over again, you would probably put it off until the end of a month or something of that sort and do it over again. Those are extreme possibilities. I can't think of having done precisely that at any time."

Spot Checking

The technique of spot checking was described by Mr. Klein as follows:

"Spot checking has three phases: There is the spot checking which occurs if the auditor is present during the inventory taking. He actually rechecks inventory items, compares the inventory list with the goods, makes his notes for his own work papers, and then compares the finished inventory sheets of the client with these field notes.

"Another phase of spot checking is throughout the year when the auditor may check selected items against perpetual inventory records or similar records.

"And the third phase is the checking of selected items in inventory against the client's inventory sheets, usually employed when the auditor was not present during inventory taking.

"In such tests due weight must, of course, be given to interim purchases and sales. In many instances the third is the only type of spot testing that is available."

The examination continued from this point.

"Q. When you say due weight, does that mean you would determine the physical quantity on hand the date you go in, and then adjust back to see how nearly it would check with the quantities supposed to have been on hand at the cut-off date?

"A. That is correct.

"Q. Would you say that the auditor would have to be familiar enough with the products to be able to identify these things? If not, how do you go about making your physical test?

"A. It is really a clerical awareness, as distinguished from a knowledge of the product itself. Merely on the basis of the record, which consists not only of the book entries and the documents, but the corresponding markings on the merchandise, whether in bins, or in original containers, or otherwise.

"Now, if by your question you mean whether the client could not substitute for what merchandise should be there, merchandise of different quality, without the auditor's being aware, granted sufficient collusion between necessary employees, that surely could be done with respect to any number of items.

"Q. Do you believe that the possibility invalidates or decreases the use of a spot test of the type you mentioned, significantly decreases it?

"A. It means absolutely if one seeks by spot testing to attain the utmost of human certainty, the goal will not be reached. It does not mean that the test has no value.

"Q. Would you say, for example, that the auditor would be entitled to rely on going to the place where the records show such material to be stored and measuring or counting it and assuming that it is the type of goods which the record has described, subject to such knowledge as you may have of the goods?

"A. Because of the recent case, and you have asked me to differentiate as between before and after, we finished recently a physical count and a test check of a large distillery warehouse.

"We noted very carefully the records of excise taxes, withdrawals and accessions, the marking both on the containers as well as on the records, and records both in and out of the warehouse.

"We did everything which justified us in accepting that the inventory presented by the client was correct, modified as we found it necessary to modify it in slight arithmetical fashion, but if you were to ask me whether the whiskey in one large container was seven years old as alleged, or six years old or eight

years old, although it showed so many gallons, or whether there might not have been alcohol and water in untested vats instead of the material alleged to be there and which we feel humanly certain is there, I couldn't answer.

"Q. Speaking generally, do you feel . . . that these physical tests nevertheless have a great deal to recommend them and should be made by auditors?

"A. Well, it is perfectly human to be empirical. They have worked in 99.876543 per cent of all cases, more or less."

Mr. Bailey testified as follows:

"Q. Is it your practice to make any spot tests of any portion of the inventory by actual count or inspection?

"A. With respect to industrial companies, we have tested inventory quantities in a substantial number of cases. Inventories are so important in an industrial territory such as Detroit, for instance, that we have advocated quantity tests for many years, and the effect of such tests for accurate inventories has proved worth-while to our clients.

"Perhaps I can state it this way: I believe that the client has a right to determine whether we shall test quantities provided we are reasonably satisfied otherwise, but that quantity tests do make for better audits and better accounting. Of course, the procedure of testing quantities does cost more, but I haven't found it to be exorbitant.

"Another feature in connection with that is the reliability of the underlying cost and inventory control. This is so important in an industrial territory that companies are quite likely to have good cost control and we have done quite a lot along that line.

"In recent years there has been an increasing tendency to be present at the time of taking inventory and making a general inspection where we do not make extensive tests. On the other hand, there are other situations, such as department stores, wholesale groceries, chain drug stores, and others of that kind, where we have not favored actual count of quantities, as the multiplicity of units or departments, the small size of items, and, particularly with the department stores, the control records and analysis of inventory make possible records that are much more indicative of the accuracy of the inventory than the tests that can be practicably made of the quantity when there is such large volume.

"There are, of course, cases where the records and the kind of inventory are such that we wouldn't feel that we could make an intelligent test of the inventory."

Messrs. Mathieson, Couchman, and Horne all indicated that they made frequent use of spot tests of inventory by actual count of inspection. Said Mr. Horne, in response to a question on this matter: "Yes, I said that this morning and I will say it again. In the specific case, the matter of observing that the material is there and in general the quantity is there, is the thing that we always want to assure ourselves of." Mr. Jones stated that his firm frequently made spot checks as they were needed. Mr. Scovill testified as follows:

"Well, I think it [spot checking] is a feasible and desirable step if the records are satisfactory against which he checks the inventory. That sort of implies a spot test with a running inventory under ordinary conditions as in a concern with proper internal check and certainly one with internal audit that is pretty well taken care of.

"Q. Now, do you think it is possible or feasible to spot check the physically taken inventories in the absence of a perpetual inventory?

"A. Well, that is possible, yes.

"The auditor would not be safe in doing it if he did not attempt to do it immediately after the inventory was taken, however. If he waits very long after the inventory is taken, a spot test might not mean so much.

"Q. He would have to work back by the records?

"A. He would have to work back."

Over-all Tests

Mr. Mathieson testified that it was definitely the practice of his firm to make over-all tests of the reasonableness of inventory quantities reported. He said: "We would compare an inventory of the current period with inventories of prior periods. We would have that inventory segregated into its various divisions to see what variations there were with respect to those divisions in the period. We would determine comparative turnovers of inventory with respect to sales, and taking general conditions into consideration use all of them in determining whether we thought the inventory values were in line or weren't. You can also determine from the company records of production sales and purchases what should or should not be there." The gross-profit test, he said, could be used to advantage with a concern manufacturing or dealing in one commodity where there is a real comparison between operating periods.

Mr. Horne's testimony on the use of over-all tests was as follows:

"A. Of course, we do make those over-all tests. Specifically as to [comparisons with] warehouse capacities, I have never had any occasion at all to think of doing that. That is a thing which might be thought of if there were huge quantities of materials on hand.

"I don't remember that I ever encountered any such experience and I feel sure I never did.

"Of course, the relation of the average consumption and purchase and the amount of production by the individual company would be a thing that would be very desirable to examine and would be examined in determining whether or not there was a likelihood that we had a great deal of obsolete or stale material on hand. . . .

"You spoke of insurance coverage. . . . It seems to me that accountants are not called on to intervene in respect of the amount of insurance carried by a company. It seems to me that that is its affair. That is an operating, a managerial matter. That is, I cannot conceive that there is anything wrong at all even as a matter of business judgment in not insuring some things. Plenty of cases there are where operating officials may very well decide that the risk was not nearly as great as the insurance premium purported to make it, but the matter of seeing that there was insurance coverage wouldn't be a thing that I would feel would be controlling in the slightest degree on whether or not there was inventory on hand. And I think that, about tax payments, that is a little more remote even than insurance coverage, because it is almost inevitably the wish of every treasurer to cut down the value of the property on which he has to pay a personal property tax.

"Q. Would you make any inquiry or investigation as to whether there is insurance?

"A. Why, we would do that inevitably as a part of the auditing routine when we came to determine whether there was or was not a deferred asset in respect of the unexpired insurance.

"Q. Now, turning to some of those tests we were mentioning a moment ago: Do you employ the gross-profits test at all?

"A. Yes.

"Q. And if so, for what purpose?

"A. To determine really whether there seems to be a general con-

sistency and reasonable relationship between the amount of inventory on hand and the amount produced, because if we seem to see a disproportionately or an unusually large gross profit, there may be a pretty fair suspicion either that the present inventory is substantially overvalued or incorrectly taken as to quantities, or that the beginning inventory may have been undervalued.

"It is part of our guide in determining whether or not there are any weak spots in the situation that we would like to see and further explore.

"Q. Likewise, if the gross profit were unusually small.

"A. Of course, it might indicate errors in the reverse direction of those I indicated before.

"Q. Should that gross-profit test be applied to the aggregate figures, or on a departmental basis?

"A. I think the answer is, of course, it ought to be applied on a departmentalized basis if it is possible reasonably to get that data available. We try always to do that and there have been times when that has been really very useful to us. I can think of two cases which come to my mind very quickly, one in which a proposed purchase of a company was not consummated because that breaking down of the inventory and the purchases and sales indicated some conditions that were not at all satisfactory to the prospective purchaser. So, I would say that in every case in which it is at all practical that should be done and, on the other hand, I recognize that very often there is a lack of the records that will permit that breaking down."

Mr. Couchman saw little of value in over-all tests of inventory quantities such as comparisons with warehouse capacities, insurance payments, average production or consumption, or trade statistics. "I don't think the accountant has a responsibility for the physical inventory," he said, "but I think he just naturally wants to satisfy himself as far as he can that there has been no misstatement. He must use whatever appeals to him as giving him confidence that the records are what they purport to be when they finally reach the form of financial statements." The gross-profits test, he said, could be useful if it were applied to truly comparable data.

Mr. Scovill felt that, with the exercise of ingenuity and care, an accountant by use of over-all tests could do much to assure himself of the reasonableness of the inventory figures. Insurance tests he felt to be inadequate. Comparisons with warehouse capacities might be useful in particular circumstances, he said, and the gross-profits test, applied on a departmental basis had value, especially in the auditing of merchandising concerns.

On the use of the gross-profits test as a check on inventory, Mr. Klein testified as follows:

"We do employ quite generally the gross-profits-percentage test, although we are fully cognizant of its limitations. . . .

"If you can departmentalize the test you limit the range of error, and therefore it is preferable not to have an over-all test for the entire merchandise, but to restrict it to groups of items. . . .

"Its employment is to some extent historical. It is used despite its limited application to test the apparent or gross correctness of the valuation of the inventory. It has a collateral use, however, in revealing abnormal trends, which may result in supplemental investigation.

"For example, gross-profits margin may be found to differ much from that of the preceding period and would then, as I say, invite investigation. If the margin decreased, that might possibly indicate one or more of the following:

1. That purchases have been inflated.
2. That sales have not been entered.

3. That the opening inventory had been valued excessively, and,
4. The closing inventory had been undervalued, and the reverse would be true if the margin went the other way.

"Investigation might reveal that the change had been brought about by a shift in the treatment of overhead as, for example, where expenditures formerly treated as manufacturing overhead, direct or indirect cost of the product, were now treated as selling expense, for example."

Additional Procedures

Each of the witnesses was asked the following question: "Looking to the future, what procedures do you think auditors should use in verifying the quantity, quality, and condition of inventories?" Mr. Mathieson's testimony on this point was as follows:

"I think the auditor has a responsibility to determine from records and from available sources what the problems of the business are and what the relationship of the inventory is with respect to its valuation. I don't think we are equipped to certify as to the correctness of technical quality, technical conditions, nor do I think we are equipped to verify physical quantities where the question of reliance on records or the nonreliance on them would be a factor. The verification that the accountant may make, in my opinion, can be of real value in the preparation of a statement.

"Q. I am not quite clear as to what you had in mind by reliance on records, or nonreliance on them in the case of verifying physical quantities.

"A. I meant by that if, for illustration, you have bales of wool that are piled in a company's warehouse preparatory to processing. There may be quite a cubical space involved. Unless you could pull out each bale and weigh it to see that the quantity was there—I am speaking now from a quantity standpoint—you would have to assume that all bales are of a like weight, which they generally are, and that back under the pile there were still bales of wool and not something else.

"So far as the quality is concerned, in no case do I think we are qualified to pass too much on that.

"Q. Speaking of the bales of wool, do you feel you are entitled to rely upon the fact that there are—

"A. I think we are because of the very way in which it is handled. You would have to have, it seems to me, connivance between a warehouseman and plant superintendent and other workmen and someone in a responsible position who would control cash in order to have anything really out of line, but if we are faced with the fact that there was that connivance, the auditor in my opinion is not in a position to find it in that way. . . .

"Packages as customarily made up to have in them the contents indicated. Then we can verify quantities in that way. If those packages had been altered or changed, unless you opened every one, then we couldn't be held responsible for them.

"Q. Do you feel that making such physical tests as you can is sufficiently of value that an auditor should undertake to do it?

"A. Personally, I think it is. I think that it helps also in the general examination in the fact that our men can see what the material the client is using or making looks like. It makes his work much more interesting and much more effective when he sees those material names appearing in the record. He can visualize quantities and qualities and convert in his mind from figures something that is tangible or existing. He can do a better job than if he doesn't know what he is talking about. . . .

"My personal feeling is that the inventory is almost the most, if not the most important item on the balance-sheet. Without a good inven-

tory, there is no reasonable expectancy of any profit. If it isn't flowing through in a normal manner, it will become stagnant or impossible to move. Then the capital of the company is so tied up that either the profits are reduced or something more serious might very well happen from it. Therefore, with the importance of the inventory, in so far as the final statement is concerned, we lay great stress in the verification as much as we can of the inventory values so as to assure ourselves that the indications both of financial position and of what might be represented by management policies are as they should be, and in forming our opinion of the financial position in the statement we give, we emphasize that point very much."

Mr. Horne testified as follows:

"Q. Looking to the future, Mr. Horne, what procedures do you think auditors should use in establishing the quality, quantity, and condition of inventory?

"A. I can't truly, Mr. Werntz, think of anything more that we should do unless we were to agree that we would take very much more of financial responsibility than I think we are called on now to take in respect of inventory.

"I think that we have been feeling that we could rely on the attitude that was expressed in that New York State Society of Certified Public Accountants resolution in respect of inventories, that when we make a statement or when we sign a report appended to a statement of financial condition in which we make no exception about inventories, we mean simply that in our capacity as accountants we have formed an opinion that the financial statement correctly and fairly represents the financial condition of the company and, to the extent that the inventories are a necessary element in determining that, we believe, it is our opinion, that the inventories have been approximately correctly stated, but that is altogether aside from any assertion that we know that the quantity is correct, that we profess any skill at all with respect to quality and that we have very much of an idea about condition.

"Q. Would you favor the participation of the auditor in the work of taking the inventory, that is, by laying out the program and supervising or being present, observing taking inventory?

"A. Yes, I would, but I just wouldn't want too many of our clients to want that done at the end of the calendar year. If we could bring about the general adoption of the natural business year so that there would be a distribution of the work throughout the year, I do believe that we could render our clients a real assistance there.

"In fact, this thing comes to my mind immediately: this particular proceeding in which we are now involved has so disturbed some of our clients that one of them made a rather peremptory demand that we have two men appear there and observe the taking of the inventory, and we did that.

"There are others who of course have changed their mind a good bit, who thought that 'Well, the accountants can't do very much about inventory, anyway, and we will just tolerate what they do,' but being a little bit discouraging about what they do. They have withdrawn from that attitude pretty thoroughly and we have a pretty clear slate and we can go ahead and do what we choose. So that I think the answer would be that it would be a good thing.

"Q. Would you necessarily have to observe the taking of the physical inventory as of the balance-sheet date?

"A. Well, if the inventory were not a thing that was auxiliary to perpetual inventories, I think that is so. . . .

"Q. If you had satisfactory perpetual inventory records, you could make tests as to the physical quantity at various times throughout the year, could you not?

"A. And I think that that is an ideal condition. I think that where perpetual inventories are kept and are well kept, the proper procedure for the company itself is to take what I have come to speak of as a rotary inventory; that is, if we were to divide it up into twelve parts in some way, take an inventory of one of such parts every month. In that case, that could be adapted very nicely to any auditor's program of laying out his work, of course, with the necessary prerequisite that the auditors had been engaged early enough in the year so as to be free to go in and do that.

"Q. You stated in answer to various of these questions that you do make some sort of physical tests of inventory by spot checking, etc.

"A. Yes.

"Q. Could you indicate whether that adds materially to the expense of the audit?

"A. Well, I wouldn't think that it added materially because I don't believe we would do any less. It is just that much. That is what it costs. If we were to omit those, if we were just to avoid doing anything at all on the inventory, time might be conserved—

"Q. That is, physically.

"A. Physically, yes, I mean physically. I believe that that might mean a fairly substantial reduction because the time of the men going out and, let us say, snooping around things which up until then they have been unfamiliar with, that does work out to a fair amount of time.

"Q. Would you put that in terms of a percentage of your aggregate audit fee?

"A. It would be the wildest kind of a guess and it would seem to me if I were to say 10 per cent, that might hit it off. That is to say, if we were to agree that we simply would not do anything at all out in the warehouse, we might whittle down 10 per cent, but if we weren't going to do anything at all about the fact of establishing whether the merchandise was there, we would fuss more on the figures and that would take up more time in another direction."

Mr. Couchman's testimony was as follows:

"A. Well, I think that corporate managements should not depend entirely upon public accountants for such control. I think the management is responsible for the custodianship of the company's assets, including inventory.

"Q. Well, from the point of view of the accountant who will certify it?

"A. Now, the accountant has to a certain extent dependence upon that honesty and integrity. I am not sure that I feel we should go further than we have been doing. Certainly I do not believe that the accountant should undertake to do something that he isn't qualified by training and experience to do. I think that would be disastrous to him and perhaps misleading to the public, if I understand your question.

"Q. Would the accountant not be qualified to, let us say, set up the procedure to be followed in taking inventory and then to observe the company in taking it?

"A. Yes, he could do that. . . .

"Q. Would you think that is desirable?

"A. Yes, provided that it is physically possible to be done. When there is such a tremendously popular use of December 31st as a date for closing fiscal years there would be quite a burden put upon the accountants who undertake it at that time.

"Q. If there were perpetual inventories, could you spread that over

the year, rather than necessarily take it December 31st?

"A. Right."

Mr. Scovill was of the opinion that the procedures for examination of inventories outlined in the bulletin, *Examination of Financial Statements,* were adequate. As for the auditor's participation in the taking of inventory, he testified:

"I think it would be well if the auditors could supervise the taking of the inventory, lay out the general plan, see that the assistants assigned to him are ones that know enough about the business and have enough integrity and there is enough internal check involved in the group so he can be reasonably sure they carry out his instructions. And if his staff can be assigned to observe the taking, and may participate to some extent in it, I think that would be a very desirable procedure. I think it is one that would not necessarily imply that the auditor should know a great amount about the product. He can inquire enough about it and learn enough about it to supervise, I believe, without really being an expert on the commodities that are being handled."

Mr. Klein's examination on procedures to be adopted in the future was as follows:

"A. I believe that in the immediate future there may be manifest, as to some extent there already is—and the latest indication of which appeared in the morning's press in connection with Schenley's—a desire on the part of the client to have the auditors participate more extensively in the preparation of inventory taking, the presence during inventory taking, tests of inventory quantities, and perhaps reliance on certificates of engineers called in especially for inventory-taking purposes.

"By the same token, I believe independent accountants may be called upon to state what they did, as well as what they did not do, in connection with the inventory taking.

"I notice in the recently published statement a reluctance on the part of some accountants to do that, but I prophesy that they will soon come to the bandwagon.

"I am disinclined to state that the present tendency will result in a permanent change. . . .

"Q. Would you say that you think it would be desirable in general to make the type of physical tests as to quantity which you have described as part of your own procedure, spot testing of one sort or another?

"A. My answer is that we try to do that in almost every case.

"Q. And do you think that would be generally desirable as a recognized audit procedure?

"A. Yes, with one word of caution. I think S.E.C. should cooperate with all other suitable agencies, governmental and private, to avoid creation of the belief that extended participation by accountants in inventory activities will guarantee that all inventories are correctly stated as to quantity, quality, condition, and value. Harm will inevitably result, I fear, if investors, credit grantors, and others are lulled into a sense of security not warranted by actualities.

"S.E.C. will, I am confident, be realistic in its approach to the subject."

Mr. Bailey's testimony was as follows:

"A. Well, I think the tests that they have been using in the past don't need to be changed except as to degree. My experience with quantity tests has led me to believe that auditors in the future can more frequently supervise or oversee the process of inventory quantities.

"However, I think we will need to be careful not to be too dogmatic

about the whole question of inventory tests, because as I said once before there are some situations where a satisfactory physical test of the inventory quantities is not practicable.

"I think perhaps there may be something to be said for an acceptance of greater participation in inventories with a definite statement as to the extent of that participation and not just a negative statement when such participation does not exist.

"Certainly we should strive for greater clarification as to whether we are reasonably satisfied with our test. And I think we should strive also to bring out more clearly that our examination as to grade, quality, and things of that kind has to be made largely from the evidence that is available from the records, because the number of cases in which inspection might show the error in grade or classification isn't very large.

"Q. You mentioned in the first part of that statement that in some situations verification of quantity wasn't practicable. Would you characterize that more fully?

"A. I am thinking again of department stores, chain stores, and things of that kind where the number of items is so large and the total of each individual item so small, that the tests of quantities would not be practically satisfactory. We could move forward on those, of course, to be present at the inventory, when it was taken, but we rely in that kind of situation upon checking the departments against one another and against prior years and against turnover figures and many other things, so that I hesitate to be so definite as to say we should in all cases participate in inventory.

"I personally have a feeling that, if we say flatly what we do and have it understood what we mean by that wording, we will find we work out to a pretty definite position for the accountant in connection with the accuracy of the inventory item.

"Q. To what extent do you think that testing physical quantities might be used as a portion of your check up on the system of internal control, as distinguished from counting to determine directly the quantity of inventory on hand? That is, sampling in the same way that you use sampling of so many sales or so many sales returns?

"A. Of course, in any inventory check, either as to quantities or condition or anything else, we rely upon test examinations of the records. Your tests go to inventories the same as they go to anything else and, if those tests are satisfactory and the records are reliable and you can use the two, you can come to some rather satisfactory conclusion on the inventory, either that you are satisfied or that you are not.

"The accuracy of the records, the way the manufacturing control is kept up, all of those things have a bearing. Where there is production control and goods are made in accordance with production schedules and there are semi-manufactured goods on the floor ready for assembly and the production department is counting on using those for manufacturing, it is a reasonable presumption that those are of a grade and quality necessary for that production."

Mr. Jones testified:

"A. The complete verification of the quantity, quality, and condition of inventory, in my mind, by auditors, is wholly impractical. The procedure of observing the taking physical inventory and spot testing quantities, I think, might be applied to a greater extent than it has been in the past, but I am not prepared to say to what extent such procedure should be extended, because I

am not convinced that from a practical point of view any material or substantial extension of those procedures would, in the last analysis, be worth their cost to industry.

"Q. How do you feel about participation and supervision of the inventory taking?

"A. I think that is important.

"Q. And would be a desirable thing?

"A. Not so much from a point of view of supervision as to observe the steps in the procedure. Also it is important, I think, to ascertain in advance of the inventory, just what a company plans to do in connection with taking inventory."

Authors of Articles In This Issue

Members of Committee on Municipal Accounting

WILLIAM R. DONALDSON, *Chairman*

T. HARLOW ANDREWS	EVERETT J. PENNY
CHARLES HENRY DYSON	O. KENNETH PRYOR
EDWARD J. GLICK	CHARLES H. ROBERTS
RAYMOND M. GREER	WILLIAM C. RHYNE
ALPHONSE M. HART	RUDOLPH J. WELTI
T. B. MAXFIELD	WILLIAM WIDER

H. T. O'BRIEN, *Director,* Bureau of Municipal Accounts, Department of Audit and Control of the State of New York

Members of Committee on Clothing Manufacturing Accounting

MICHAEL PEYSER, *Chairman*

JULIUS S. AUSLANDER	FRED I. LANDAU
SOL FEDERGREEN	GEORGE L. MARKS
A. ALBERT GREENSPAN	MORRIS POMERANTZ
GEORGE N. JANIS	LOUIS H. ROSOFF

HARRY A. SCHARF

208
PRINTED IN U. S. A.